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Litigating Executive Compensation Disputes and How to Avoid Them

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Disputes concerning executive deferred compensation plans raise a unique set of issues distinct from ordinary ERISA claims litigation. These issues are significant both for litigation involving such plans and from a plan drafting and litigation avoidance perspective. The most fundamental issue in evaluating the litigation risks surrounding an executive compensation dispute is whether the plan at issue is governed by ERISA. Nonqualified deferred compensation plans generally fall into two categories:

1. Retirement plans that generally qualify as “employee pension benefit plans” under ERISA; and

2. Non-retirement equity or performance-based plans that do not “systematically” defer income until retirement.

Non-qualified retirement plans are either:

1. “Excess benefit” plans, which are completely exempt from ERISA; or

2. “Top hat” plans, which are generally subject to ERISA, but exempt from its vesting and accrual, fiduciary, and reporting provisions.

Deferred compensation plans that do not provide for retirement income are not subject to ERISA at all.

Whether a deferred compensation plan is subject to ERISA or not, there are a number of interpretative issues, such as the ability to amend and change in control provisions, which are significant in the executive compensation context.

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Applicability of ERISA

What Qualifies as an “Employee Pension Benefit Plan”?  

ERISA’s definition of an “employee pension benefit plan” includes “any plan, fund, or program” that “provides retirement income to employees for periods extending to the termination of covered employment or beyond.” As discussed below, both excess benefit and top hat plans fall within this definition, although there is a statutory exemption for top hat plans.

Clearly, equity- or performance-based deferred compensation plans that do not provide “retirement income” are not “employee benefit pension plans” within the meaning of ERISA. According to Department of Labor (DOL) regulations, the terms “employee pension benefit plan” and “pension plan” do not include “payments made by an employer to some or all of its employees as bonuses for work performed, unless such payments are systematically deferred to the termination of covered employment or beyond, or so as to provide retirement income to employees.”

Incidental Retirement Income

It is frequently the case that a deferred compensation plan will or could incidentally provide some income after retirement. The courts have generally held, however, that incentive stock option or bonus plans are not ERISA plans even if they provide for some income beyond retirement. For example, in a seminal case, the Fifth Circuit held the mere fact that some payments under a plan may be made after an employee has retired or has left the company does not result in ERISA coverage.

Similarly, the Third Circuit, in Oatway v. American International Group, Inc., has held that a stock option incentive plan was not an ERISA plan even though the stock options could be exercised after retirement. The Oatway court relied on the facts that the plan was not created for the purpose of providing retirement income, but rather was designed to provide financial incentives for key employees, and that the stock options were discretionary and awarded in addition to the employee’s regular compensation.

Phantom Stock

In a case addressing a phantom stock plan, Emmenegger v. Bull Moose Tube Co., the Eighth Circuit held that the plan was a bonus plan excepted from ERISA coverage. In Emmenegger, the phantom stock could be redeemed during employment, although stock grants did not immediately vest and there was an initial five-year holding period at the plan’s inception. Further, the value of the phantom stock
was tied to the sponsor's financial performance, not the value at retirement or termination of employment. Accordingly, the court found:

While a participant may postpone his redemption of PSP shares until termination or retirement, this is strictly at the option of the participant, and there is nothing in the terms of the program that would result in such deferral with the purposeful consistency required to make deferral systematic.7

Excess Benefit Plans

Even a plan that meets ERISA's definition of an "employee pension benefit plan" is exempt from Title I of ERISA if it qualifies as an "excess benefit plan."8 ERISA Section 3(36) defines an "excess benefit plan" as:

...a plan maintained by an employer solely for the purpose of providing benefits for certain employees in excess of the limitations on contributions and benefits imposed by section 415 of the Internal Revenue Code of 1986 on plans to which that section applies, without regard to whether the plan is funded.9

Because of the statutory requirement that such plans be established "solely" for the purpose of providing benefits in excess of the Section 415 limits, any other purpose may take a plan outside the definition of an excess benefit plan.

Because Title I of ERISA does not apply to excess benefit plans, state laws that relate to such plans are not preempted.10 Accordingly, claims for benefits under excess benefit plans may be brought under state law, including claims for consequential and punitive damages, as well as a demand for jury trial.

Top Hat Plans

Parts 2 and 4 of Title I of ERISA do not apply to "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...."11 Such plans are commonly referred to as "top hat" plans.

The statutory criteria for identifying top hat plans are relatively straightforward, with the exception of the somewhat vague "select group" requirement. The Second Circuit has provided a helpful list of the following factors weighing in favor of a finding that the "select group" requirement has been satisfied:

- The plan was supplemental to a regular pension plan;
- The plan provided generous benefits;
• The plan was established as a means to retain valuable employees; and

• The participants were in management positions and highly compensated in comparison to the universe of employees at large.¹²

The Demery¹³ court, in Demery v. Exebank Deferred Compensation Plan (B), also noted that the ability of participants to negotiate the terms of the plan is an important component of top hat plans.¹⁴ This is true because Congress deemed higher-paid employees, unlike most employees, to be capable of protecting their own pension expectations. The test is, thus, primarily qualitative rather than quantitative.

Because a top hat plan is subject to ERISA's enforcement provisions and is an employee benefit plan within the meaning of ERISA, all state law claims that relate to such a plan are preempted.¹⁵ However, as discussed below, it is less clear whether top hat plans are also subject to the arbitrary and capricious standard of review or the exhaustion requirement that ordinarily applies in ERISA litigation.

Procedural Issues

Standard and Scope of Review

The US Supreme Court has held that if an ERISA plan's terms grant an administrator discretion authority to interpret the plan, courts must show deference for the administrator's determinations.¹⁶ Accordingly, where the plan confers discretion, federal courts review administrative benefit decisions under the highly deferential "arbitrary and capricious" standard.¹⁷

Further, because the issue before the court is a review of the administrator's decision, the scope of the court's review is generally limited to the information before the administrator during the administrative process.¹⁸ The effect of this rule is to substantially limit discovery, and thus the expense of benefits litigation.¹⁹ However, the courts are split on the question of whether the arbitrary and capricious standard of review also applies to top hat plans. For example, the Third Circuit has held that de novo review applies to top hat plans even when the administrator has discretionary authority because "a top hat administrator has no fiduciary responsibilities" under ERISA.²⁰ According to the Third Circuit, "top hat plans should be treated as unilateral contracts" and reviewed "in accordance with ordinary contract principles."²¹

The Third Circuit reasons that the policy considerations relied upon by the US Supreme Court in holding that an abuse of discretion standard applies to ERISA plans, such as the analogy to trust law and
ERISA's fiduciary responsibility requirements, are not applicable to top hat plans. However, both the Third and Eighth Circuits have also recognized that a grant of discretion in a top hat plan is still entitled to some consideration under ordinary contract principles. According to the Third Circuit, a grant of discretion in a top hat plan:

...must be read as part of the terms of the unilateral contract itself. As a term of the contract, it must be given effect as ordinary contract principles would require... Ordinary contract principles require that, where one party is granted discretion under the terms of the contract, that discretion must be exercised in good faith—a requirement that includes the duty to exercise the discretion reasonably.

Thus, in these circuits the relevant standard can best be described as a hybrid standard focusing on whether the administrator's decision was "reasonable" rather than just not arbitrary or capricious.

Other courts, however, have applied the arbitrary and capricious standard to top hat disputes. Some of the courts adopting this position have reasoned that the US Supreme Court in Firestone expressly noted that "we do not rest our decision on the concern for impartiality that guided the Court of Appeals, [and] we need not distinguish between types of plans or focus on the motivations of plan administrators and fiduciaries."

Whether or not a dispute is likely to be brought in a jurisdiction that applies the arbitrary and capricious standard to top hot disputes, it is always wise to insist on compliance with the administrative procedures set forth in the plan as well as ERISA's requirement. Failure to comply with the proper claim procedures can result in a loss of the arbitrary and capricious standard.

Further, non-compliance with administrative requirements can itself be evidence of an arbitrary and capricious decision.

Exhaustion of Administrative Remedies

For ordinary ERISA plans, the rule is clear that if a plan provides an administrative process for claiming plan benefits, that process must be exhausted before a lawsuit can be brought for benefits under ERISA. Although there is a lack of case law, it is likely that the exhaustion requirement applies to top hat plans also.

Many courts have recognized that the statutory underpinning for the exhaustion requirement is ERISA Section 503, which requires plans to have a claims procedure. ERISA Section 503 is part of Part 5 of ERISA (Administration and Enforcement), which is applicable to top hat plans. Accordingly, there is little justification, and no authority, for exempting top hat plans from the exhaustion requirement.
Further, although excess benefit plans are exempt from all ERISA requirements, including the exhaustion requirement, it is prudent to include an administrative claim review procedure in such plans. As excess benefit plans work in conjunction with qualified plans, and disputes often involve both types of benefits, there are certain efficiencies associated with incorporating a qualified plan's administrative procedure into a corresponding excess benefit plan. The courts, as noted above, will likely enforce an administrative requirement as a contractual term, particularly where a dispute involves both qualified and non-qualified benefits.\textsuperscript{32}

\textbf{Substantive Issues}

\textbf{Amending Nonqualified Plans}

Because a number of golden parachute and other types of executive severance plans are keyed to changes in corporate control, whether such plans can be amended is an issue that occurs with some frequency. Although the opinions can be difficult to harmonize, generally courts have looked to ordinary contract principles to enforce clauses expressly permitting amendments. However, even in the face of such provisions, some courts have refused to permit amendments that would defeat rights after the contractual conditions precedent has been satisfied.

For example, in \textit{Threadgill v. Prudential Securities, Inc.},\textsuperscript{33} the plaintiffs sued a top hat plan for change in control benefits following the plan sponsor's amendment to disarm the trigger for "change in control" benefits shortly before the company was sold. The plaintiffs contended that the amendment was invalid because it impermissibly reduced plan benefits. The court rejected the plaintiffs' claim.

\begin{quote}
Under any fair reading of the...Plan, a Change of Control must actually take place—not merely be contemplated in the future—for the benefits to vest. As the Agreement and Plan of Merger contain several conditions precedent or contingencies, any one of which, if unmet, would have precluded occurrence of the merger, the mere signing of that agreement would not have been sufficient in itself, to trigger a Change of Control.\textsuperscript{34}
\end{quote}

The Court went on to note:

\begin{quote}
The widely-accepted purposes for including Change of Control benefits in employee benefit plans—to (1) fend off hostile takeovers and (2) assure key employees that they will be fairly compensated in the event of a hostile takeover by depriving corporate raiders of the power to prevent such payment—could not have been furthered by recognizing the accrual of Change of
\end{quote}
Control benefits. The Agreement and Plan of Merger embodied a consensual business transaction, and the beneficiaries accepted the annuity benefit.\textsuperscript{35}

In contrast, other courts have used unilateral contract principles to invalidate amendments that would defeat rights that have already been earned.\textsuperscript{36} In \textit{Kemmerer v. ICI Ams. Inc.},\textsuperscript{37} a top hat plan allowed Plan participants to elect the manner in which their salary deferrals would be distributed at retirement. Plaintiffs retired and made elections regarding the receipt of their deferred income. Subsequently, the Company amended the Plan to provide that the account balances to be paid to retired Plan participants would be paid in three annual installments with a 10 percent interest on unpaid balances. Plaintiffs contended the amendment could not be applied retroactively to them. The Third Circuit held:

\textit{...the Plan constitutes an offer that the employee, by participating in the Plan, electing a distributive scheme, and serving the employer for the requisite number of years, accepts by performance. Under unilateral contract principles, once the employee performs, the offer becomes irrevocable, the contract is completed, and the employer is required to comply with its side of the bargain...As a corollary, \cite{subsequent unilateral adoption of an amendment which is then used to defeat or diminish the [employees] fully vested rights under the governing Plan document is...ineffective.}\textsuperscript{38}

Similarly, the Third Circuit has invalidated a retroactive amendment to a top hat plan, despite plan language that permitted amendments “at any time for any reason.”\textsuperscript{39} According to the \textit{New Valley} court,\textsuperscript{40} if benefits could be amended out of existence after participants had fully performed, the contract would be illusory. As a result, the court held that the words “at any time” were ambiguous, which allowed the plaintiff to introduce parol evidence regarding the intent of the parties.\textsuperscript{41}

Despite cases like \textit{New Valley}, it is clearly a prudent drafting practice to include amendment provisions that are as broad as possible in deferred compensation plans. Further, when drafting amendments, the focus should be, to the greatest extent possible, on prospective benefits or events.

\section*{Integration Clauses}

Unlike qualified plans, non-qualified plans do not benefit from what some courts have described as ERISA’s statutory integration requirement. ERISA requires that: “Every employee benefit plan shall be established and maintained pursuant to a written instrument.”\textsuperscript{42} Several courts have referred to this requirement as at least
part of the rationale for holdings limiting litigants to the language of the plan document. According to the Third Circuit, Section 1102(a)(1):

...essentially operates as a strong integration clause statutorily inserted in every plan document covered by the fiduciary duty provisions. Like any common law integration clause, § 1102(a)(1) makes the plan document the entire agreement of the parties and bars the introduction of parol evidence to vary or contradict the written terms.

... As a result, top hat agreements can be partially or exclusively oral. They may, of course, be integrated by their own terms, just as they may contain any provision to which the parties agree.

Thus, in the absence of an integration clause, evidence of the parties’ intent beyond the terms of the agreement itself, or additional terms of the agreement, may be admissible. From a drafting perspective, therefore, it makes sense to include merger clauses in all deferred compensation plans. Otherwise, there is a risk that the scope of benefits disputes will expand beyond the terms of the plan and into oral representations and other evidence of intent.

Notes

2. 29 C.F.R. § 2510.3-2(c).
3. Murphy v. Inexco Oil Co., 611 F.2d 570, 576 (5th Cir. 1980).
4. 325 F.3d 184 (3d Cir. 2003).
5. Oatway, 325 F.3d at 188 (“Oatway’s post-retirement payments were only incidental to the goal of providing current compensation.”).
6. 197 F.3d 939 (8th Cir. 1999).
7. Emmenegger, 197 F.3d at 933; see also McKinsey v. Sentry Ins., 986 F.2d 401, 406 (10th Cir. 1993) (“The plan permits a sales representative to withdraw the vested portion of his/her allocations at any time during the course of her/his employment; it does not provide for the systematic deferral of payment.”).
8. ERISA § 4(b)(5) (29 U.S.C. § 1003(b)(5)).
9. ERISA § 3(36) (29 U.S.C. § 1002(36)).
11. ERISA § 201(2) (29 U.S.C. § 1051(2)).
13. Id. at 289.


17. Id.

18. Some courts have allowed narrowly tailored discovery to examine the proper standard of review or define the scope of the administrative record. See, e.g., Hensley v. Northwest Permanent & Retirement Plan, 5 F. Supp. 2d 887 (D. Or. 1998) (discovery limited to determination of proper standard of review); Cernito v. Liberty Life Assurance Co. of Boston, 209 F.R.D. 663 (M.D. Fla. 2002) (discovery permitted to determine information considered by fiduciary).

    See, e.g., Lee v. Blue Cross/Blue Shield of Alabama, 10 F.3d 1547 (11th Cir. 1994) (“Application of the arbitrary and capricious standard requires us to look only to the facts known to the administrator at the time the decision was made….”).

19. See, e.g., Perlman v. Swiss Bank Corp. Comprehensive Disability Protection Plan, 195 F.3d 975 (7th Cir. 1999) (collecting ERISA cases refusing to allow discovery); Liston v. UNUM Corp. Officer Severance Plan, 330 F.3d 19, 25–26 (1st Cir. 2003).


21. Id.

22. Id.; see also Craig v. The Pilsbury Non-Qualified Pension Plan, 458 F.3d 748, 752 (8th Cir. 2006) (following Goldstein).

23. Goldstein v. Johnson & Johnson, 251 F.3d at 444.


26. Towne v. Cigna Life Ins. Co., 419 F. Supp. 2d 172, 180 (D. Conn. 2006) (failure to deliver timely decision on claim resulted in de novo review); but see Gatti v. Reliance Standard Life Ins. Co., 415 F.3d 978 (9th Cir. 2005) (procedural violations of ERISA do not alter the standard of review unless those violations are so flagrant as to alter the substantive relationship between the employer and employee, thereby causing the beneficiary substantive harm).

27. See Helms v. General Dynamics Corp., 2007 WL 595877 at *12 (11th Cir. Feb. 27, 2007) (“We find it is unreasonable, and therefore arbitrary and capricious, for Aetna to have repeatedly sheathed its true justifications in boilerplate language in its first three denial letters to Helms.”); Newell v. Prudential Ins. Co. of Am., 904 F.2d 644, 653 (11th Cir. 1990) (“We believe that the undue delay in notifying Newell of the length of hospital stay had been approved or disapproved and the delay in or failure to notify Newell of placing the case in retro review status constitutes arbitrary and capricious conduct on the part of Prudential.”); but see Militello v. Cent. States, Southeast & Southwest Areas Pension Fund, 360 F.3d 681 (7th Cir. 2004)
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("Militello does not complain...that the failure of the Fund to follow its appeal procedures deprived him of any of these 'core requirements.' Thus, we cannot say that failure to follow the appeal process to the letter, without more, necessarily deprived Militello of full and fair review."); Buttram v. Cent. States, Southeast and Southwest Areas Health & Welfare Fund, 76 F.3d 896 (8th Cir. 1996) ("Although the procedural irregularities in this case give us pause, they do not demonstrate that the actual decision reached in 1994 was arbitrary or whimsical.").

28. See, e.g., Gayle v. UPS, 401 F.3d 222 (4th Cir. 2005).

29. See generally Eastman Kodak Co. v. STWB, Inc., 452 F.3d 215 (2d Cir. 2006) (analyzing whether amendment adding exhaustion requirement to top hat plan could be made retroactive without questioning applicability of requirement).


31. Gayle, 401 F.3d at 228; see also 29 U.S.C. § 2560.503-1 (detailing requirements of claim procedures).

32. Goldstein, 251 F.3d at 444 (terms of top hat plan must be given effect under ordinary contract principles).

33. 145 F.3d 283 (5th Cir. 1998).

34. 145 F.3d at 294.

35. 145 F.3d at 295; see also Burns v. Rice, 39 F. Supp. 2d 1350 (M.D. Fla.), affd without opinion 210 F.3d 393 (11th Cir. 2000) (change in control benefits could be amended prior to change in control).


37. Id.

38. Kemmerer, 70 F.3d at 287 (quoting Pratt v. Petroleum Prod. Management Employee Sav. Plan, 920 F.2d 651, 661 (10th Cir. 1990)).


40. Id.

41. Id. at 152.

42. 29 U.S.C. § 1102(a)(1).

43. See, e.g., Hozier v. Midwest Fasteners, Inc., 908 F.2d 1155, 1163–1164 (3rd Cir. 1990) (collecting cases).

44. In re New Valley, 89 F.3d 143, 149 (3d Cir. 1996).

45. Id.