

Recent Court Decision May Alter Approach to Incentive Compensation and Deferred Compensation

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Summer 2014

In creating incentive compensation programs, there is often an element added to increase retention as well as to provide a tax deferral opportunity and additional long-term savings for participants. As more provisions are added to incentive plans, additional care must be followed to avoid potential pitfalls. A recent U.S. Court of Appeals case provided by the Fifth Circuit (*Tolbert v. RBC Capital Markets Corp.*) highlights this importance and may in fact alter certain historical approaches. The opinion states that a deferred compensation plan through which RBC financial advisors received annual bonuses and made other income deferrals was an “employee pension benefit plan” governed by the Employee Retirement Income Security Act of 1974 (ERISA). Although the RBC plan’s primary purpose was not to provide retirement income, the court ruling indicated that it nevertheless was governed by ERISA because its express terms “resulted in a deferral of income by employees for periods extending to the termination of covered employment or beyond.”

By way of background, ERISA’s coverage extends to, among other types of plans, “employee pension benefit plans.” An employee pension benefit plan, in turn, is defined as “any plan, fund, or program” that, “by its express terms or as a result of surrounding circumstances,” either “(i) provides retirement income to employees, or (ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond.”

The plan at issue in *Tolbert* was RBC’s Wealth Accumulation Plan (WAP). The WAP was a deferred compensation plan through which participants (RBC financial advisors) could defer a portion of their annual pay. It was also the exclusive vehicle through which RBC paid financial advisors annual productivity bonuses. In *Tolbert*, the WAP provided for participant deferrals (mandatory and voluntary) and matching contributions that was to be distributed to the participant when the amounts vested. Participants had the option, however, to defer distribution until a later in-service distribution date or until termination of employment.

The WAP’s stated purpose was to allow a “select group of management or highly compensated employees” to defer a portion of their annual pay in an effort to promote “long-term savings to allow such employees to share in RBC’s growth and profitability, if any.” The WAP was expressly designed so that, in the event that it was determined to be an employee pension benefit plan under ERISA, it would constitute a “top hat” plan (Note: The term “top hat” plan refers 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.” ERISA expressly exempts top hat plans from its vesting, funding, and fiduciary duty requirements).

The *Tolbert* plaintiffs are former RBC employees who participated in the WAP and who, upon their termination from employment at RBC, forfeited some of their WAP benefits pursuant to the express terms of the plan. The plaintiffs sued RBC for breach of fiduciary duty under ERISA,

seeking to recover their forfeited benefits on the theory that the plan was not a valid top hat plan, and thus, the forfeiture of their plan benefits violated ERISA.

One of the issues in the case involves the U.S. Department of Labor's (DOL's) "bonus program" regulation. That regulation states that the "employee pension benefit plan" definition "shall 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." The court explained that the WAP was not a "bonus program" but rather was a self-described "deferred compensation plan," and, thus, the DOL regulation was inapplicable.

Implications for Incentive Compensation and Deferred Compensation Plans

So why is ERISA coverage of the WAP relevant? For some compensation and benefit plans, employers want the protections (and obligations) that ERISA provides. However, for other plans, employers must avoid ERISA coverage at all costs. Three plaintiffs who forfeited their WAP benefits upon termination of employment (two of whom were financial consultants at the company and one of whom was an administrative assistant) sued to recover those benefits by claiming that the WAP's forfeiture provisions violated ERISA. The company argued that the plan was not subject to ERISA because it was not a pension benefit plan. The Fifth Circuit disagreed and remanded the case to the District Court to determine if the WAP qualifies for another exception from ERISA. If the WAP does not qualify for the "top hat" plan exemption, it may not be able to cause the forfeiture of plaintiffs' benefits meaning that an ERISA plan was created, which may result in a variety of other issues for the company.

Furthermore, the *Tolbert* decision has important implications for employers that create incentive compensation plans and use deferred compensation arrangements with an understanding that the particular arrangement does not constitute an ERISA-governed pension plan. The decision also indicates that the DOL's "bonus program" regulation does not apply to plans that provide bonuses alongside other forms of deferred compensation.

Employers should note that although the *Tolbert* decision is a Fifth Circuit decision, its rationale may have broader applicability. Consider the following:

- A "Top-hat" plan must be properly designed by delineating the top hat group
- Whether a bonus plan and a deferred compensation should be under separate arrangements
- Whether an arrangement gives rise to the "systematic" deferral of payment to termination or beyond depends on the facts and circumstances of the arrangement, including:

- Whether arrangement's design results in a high percentage of bonus payouts being made at or near recipients' retirement age;
- Whether the employer communicates the plan to employees as an arrangement intended to provide retirement or deferred income;
- Whether the arrangement allows for payments of unvested amounts upon employment termination;
- The length of the payout period;

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