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Pulling Tricks out of a Top Hat: Preemption of Non-Compete Laws Applicable to "Top-Hat" Plans

by Amy L. Blaisdell and Wendy S. Menghini

Employers often create deferred-compensation benefit plans as a means for select groups of highly compensated employees to supplement retirement savings. These plans are more commonly referred to as ERISA "top-hat" plans.

Congress, recognizing 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, taking into consideration any risks attendant thereto," has determined that top-hat plan participants do not require the protection of the substantive rights and protections provided by Title I of ERISA. DOL Opinion Letter 90-14A, 1990 ERISA LEXIS 12, at*3-4 (May 8, 1990).

As a result, ERISA top-hat plans are exempt from ERISA's fiduciary responsibility provisions (29 U.S.C. §§ 1101-1114), participation and vesting provisions (29 U.S.C. §§ 1051-1061), and funding provisions (29 U.S.C. §§ 1081-1086). However, top-hat plans are still subject to ERISA's reporting and disclosure provisions (29 U.S.C. §§ 1021-1031) and its administration and enforcement provisions (29 U.S.C. §§ 1131-1145). *Accardi v. IT Litig. Trust*, 448 F.3d 661, 664-665 (3d Cir. 2006); *Demery v. Extebank Deferred Compensation Plan (B)*, 216 F.3d 283,

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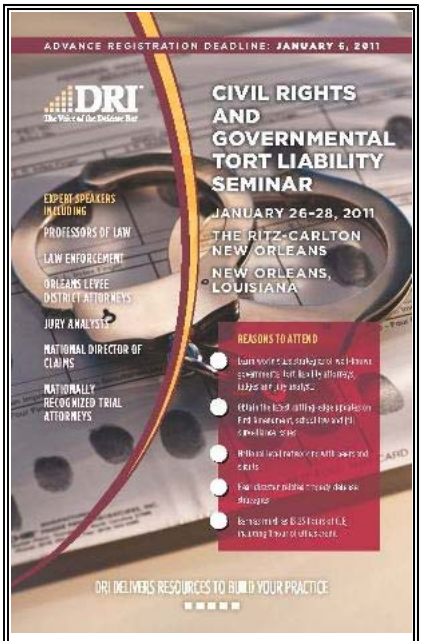

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286-87 (2d Cir. 2000); *Olander v. Bucyrus-Erie Co.*, 187 F.3d 599, 604 (7th Cir. 1999).

As is suggested above, top-hat plans are non-qualified, deferred-compensation plans which are exempt from the non-forfeitability provisions of ERISA, 29 U.S.C. §§ 1051-1061. Executives may fund their accounts with pre-tax payroll deductions, or the employer may make tax-deferred contributions. However, the deferred compensation benefit must remain an asset of the employer until it is paid out to the participant.

Non-compete clauses are often included in top-hat plans as a method to bind the executive to the employer. With respect to tax-exempt employers, non-compete provisions have often been included in non-qualified deferred compensation arrangements to satisfy the requirement under Internal Revenue Code § 457 (f) that amounts deferred remain subject to a substantial risk of forfeiture until paid.

Litigation routinely ensues when a non-competition provision is violated and the plan administrator denies payment of the deferred compensation benefits, finding that the benefits have been forfeited. In these circumstances, plaintiffs almost always allege state law violations and argue, under state restrictive covenant law, that the non-competition provisions are unenforceable.

Defendants, on the other hand, usually assert that the plan is a top-hat plan, that the claims are preempted by ERISA, and that the terms of the top-hat plan and federal common law apply and require forfeiture of the benefit.

This article reviews the few federal cases that have squarely addressed this issue and summarizes other federal case law which strongly supports the conclusion that state non-competition laws are preempted by ERISA and should play no role in the federal courts' review of cases involving the forfeiture of benefits under an ERISA top-hat plan.

Enforcement of Non-Compete Provisions in Top-Hat Plans

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Several courts have recognized that the public policy that applies to restrict the enforcement of non-competition clauses in the employment context is not equally applicable to the forfeiture of employee benefits. These courts have reasoned that, unlike a covenant not to compete in an employment agreement, a forfeiture clause does not prevent an employee from working in a specific field and does not threaten one's livelihood.

Instead, it exacts a certain cost (the forfeiture of benefits) on the employee for exercising his or her right to compete. *See, e.g., Schlumberger Technology Corp. v. Blaker*, 859 F.2d 512, 516 (7th Cir. 1988) ("An offer of benefits contingent on not competing holds less threat to the employee and the competitive process than does judicial enforcement of a [covenant not to compete]."); *Tatom v. Ameritech Corp. and Ameritech Information Systems, Inc.*, 305 F.3d 737, 744 (7th Cir. 2002) ("Federal cases draw a distinction between provisions that prevent an employee from working for a competitor and those that call for a forfeiture of certain benefits should he do so."); *Viad Corp. v. Houghton*, 2010 WL 2559874 (N.D. Ill. 2010) (same).

Thus, defendants vigorously assert that state law, which restricts the enforceability of non-competition clauses, is not applicable in the context of an employee benefit forfeiture provision. Nevertheless, plaintiffs sometimes argue that because top-hat plans are not subject to some of ERISA's provisions, state law should be applied in interpreting the forfeiture provisions or should be used to fill ERISA's gaps. This is particularly true when the claim arises in a state that has a statute prohibiting non-competition clauses or a public policy which strongly disfavors limitations on competition.

Courts Addressing Forfeiture Clauses Have Upheld Them

At this time, only a handful of federal courts have squarely addressed the issue of the enforceability of forfeiture clauses in ERISA top-hat plans. The good news for defendants is that these courts

have uniformly found the forfeiture clauses to be enforceable under ERISA and subject to interpretation pursuant to the terms of the ERISA plan and federal common law.

Several years ago, the United States District Court for the Southern District of New York expressly determined that federal common law governs the application of a non-compete provision in a top-hat plan, and this decision was affirmed on appeal. *See Bigda v. Fischbach Corp.*, 898 F.Supp. 1004, 1014 (S.D.N.Y 1995), *affd without opinion* at 101 F.3d 108 (2d Cir. 1996).

In *Bigda*, the plaintiff asserted that a provision of his employment agreement was unenforceable under both New York law and ERISA to the extent that it subjected his benefits under a top-hat plan to forfeiture, if, prior to the age of 65, he accepted employment that the company's board of directors deemed to be competitive with the company or any of its subsidiaries. After concluding that the plan was indeed a top-hat plan, the district court concluded that based on its reading of the language of ERISA, state law was not preempted.

The court then reconsidered its own ruling, finding that ERISA preempts all state law causes of action relating to top-hat plans. In reaching this conclusion, the court noted that top-hat plans are not exempt from the administration and enforcement provisions of ERISA, 29 U.S.C. §§ 1131-1145. The court then observed that the administrative and enforcement provisions were most important to its analysis, since the preemption provision is found at 29 U.S.C. § 1144.

The court concluded: "It is clear that the provisions of the administration and enforcement section of ERISA apply to top hat plans. For example, the provision providing a federal cause of action for violations of the terms of a plan applies to top hat plans. ... It would be illogical for top hat plans to be subject to some of the administration and enforcement provisions of ERISA and not to others."

The court further noted that the goals underlying ERISA's preemption of state laws indicate that all plans covered by ERISA should be protected by preemption. *Id.* at 1004 (citing *Fort Halifax Packing Co. v. Coyne*, 482 U.S. 1, 9-11 (1987)). "There is no reason that top hat plans, unlike all other ERISA-covered plans, should be subject to a patchwork of different state laws." *Id.* Plaintiff appealed to the Second Circuit, which affirmed the decision without opinion.

The Third Circuit likewise held that top-hat plan forfeiture clauses should be construed under ERISA and federal common and not under state law in *Koenig v. Automatic Data Processing*, 156 Fed.Appx. 461, 467-68 (3d Cir. 2005). Although the court recognized that a federal court may look to state law in fashioning federal common law, it noted that a court may do so only if the state law is consistent with ERISA.

In *Koenig*, the district court entered judgment in the plan participant's favor, applying New Jersey law (which disfavored non-competition agreements) and finding that the participant's breach was not "material." The appellant, ADP, argued that the district court had erred in applying New Jersey law. The Third Circuit agreed stating:

> The Court did not cite or apply federal common law in its discussion of whether Koenig's alleged breaches of the Agreement and whether any such breaches were "material." Instead, without explanation, the Court applied New Jersey law, citing opinions by the Supreme Court of New Jersey and federal courts construing New Jersey law in diversity cases, and adhered, specifically, to New Jersey law principles of "forfeiture" in denying ADP the right to withhold benefits as the Agreement provides by its terms. Moreover, the District Court failed to consider whether the issue of materiality is a fact issue under federal law and, therefore, not appropriate for summary judgment.

Id. at 467.

The court then noted that if there is no established federal common law on a given issue, the court may consult state law, as a guide to fashioning a federal rule that is *consistent with the policies underlying the federal state in question*. However, the court noted that the district court did not provide any assurance that New Jersey law should have served as a guide.

Because the court could not be sure that the district court would have arrived at the same conclusion if it had applied federal common law, "or established an appropriate rule of federal law to govern in the absence of one," the court reversed judgment and remanded to the district court to interpret the agreement under federal common law in the first instance. *Id.* at 467.

The Third Circuit's analysis strongly supports the argument that any state case law that strikes down or restricts the enforcement of a forfeiture clause should not serve as the basis for federal common law under ERISA because such state law would prohibit the enforcement of express plan terms and potentially alter the overall structure of the plan.

District Courts Also Have Upheld Non-Compete Provisions

Besides the Second and Third Circuits, a few district courts have upheld non-compete provisions in top-hat plans based on ERISA's preemption of state law and the application of federal common law. In fact, the United States District Court for the Northern District of Illinois enforced an extremely broad non-compete forfeiture provision in a top-hat plan in *Spitz v. Berlin Indus., Inc.*, 1994 WL 194051 (N.D. Ill. 1994).

In *Spitz*, the district court held that a non-compete forfeiture provision in a top-hat plan was enforceable, and specifically noted that state non-compete law should not be considered. The court expressly noted that the absence of any provisions in ERISA governing the forfeitability of benefits in top-hat plans does not mean that the court should apply state law concerning

covenants not to compete. *Id.* at *3.

At least one district court within the Sixth Circuit has applied federal common law to find a forfeiture provision in a top-hat plan permissible if the plan contains clear language to this effect. *Foley v. American Electric Power*, 425 F.Supp.2d 863, 871 (S.D. Ohio 2006).

Although most circuits have yet to address the question of whether state non-compete/forfeiture law is preempted by ERISA in the context of a top-hat plan, the foregoing cases provide a solid framework on which defendants can build to support the argument that forfeiture clauses are enforceable and should be interpreted under federal law alone.

Furthermore, several older cases considered whether forfeiture clauses which applied to benefits in excess of the minimum vesting requirements were enforceable. In these cases, the federal courts routinely held that state forfeiture and non-compete laws should play no role in the analysis. *See, e.g., Clark v. Lauren Young Tire Center Profit Sharing Trust*, 816 F.2d 480 (9th Cir. 1987); *Noell v. American Design, Inc., Profit Sharing Plan*, 764 F.2d 827, 830-31 (l1th Cir. 1999); *Hepple v. Roberts & Dybdahl, Inc.*, 622 F.2d 962, 966 (8th Cir. 1980); *Brower v. Comark Merchandising*, 949 F.Supp. 1183, 1188 (D.N.J. 1996).

Additionally, several federal circuit courts have held that ERISA preempts state law concerning top-hat plans. For example, the Fifth Circuit has squarely held that ERISA preempts state law claims related to top-hat plans if the underlying conduct upon which the claim is based cannot be severed from its connection to the plan. *See Reliable Home Health Care v. Union Central Ins. Co.*, 295 F.3d 505, 515-16 (5th Cir. 2002).

Both the Seventh and Eleventh Circuits have reached the same conclusion. *See Garratt v. Knowles*, 245 F.3d 941, 948 (7th Cir. 2001) (finding that ERISA preempts state tortious interference, civil conspiracy, and unjust enrichment claims involving top-hat plans), and *Holloman v. Mail-Well Corp.*, 443 F.3d 832, 837

(11th Cir. 2006) (breach of contract claims preempted by ERISA). *See also Lemanski v. Lenox Savings Bank*, 1996 WL 253315, at *13 (D. Mass. 1996) (holding that an ERISA top-hat plan preempts state law claims that, in order to prevail, must plead that an ERISA plan exists).

As it stands, the only outlier is the Fourth Circuit. Notably, no court in the Fourth Circuit has squarely addressed the enforcement of a non-compete provision in an ERISA top-hat plan. However, at least one district court in the Fourth Circuit has allowed state law claims related to top-hat plans. *See Alfa Laval, Inc. v. Nichols*, 2007 WL 984111, at *11 (E.D. Va. 2007).

This treatment of ERISA top-hat plans may indicate a willingness to apply state law to non-compete clauses in top-hat plans. But as case law continues to develop in the other circuits it will likely highlight the fact that this decision is the minority view, and as a result, we anticipate that courts in the Fourth Circuit will eventually move to the majority view.

Conclusion

In summary, a few key points should be taken from the status of the federal law governing forfeiture provisions in ERISA top-hat plans:

- There is strong support in the federal law for the conclusion that state non-competition and state forfeiture laws are preempted by ERISA and should play no role in the enforcement of ERISA top-hat plan forfeiture provisions.
- The federal courts have recognized that it is appropriate to apply federal common law to analyze forfeiture provisions, and the cases discussed herein provide authority for the position that forfeiture clauses are enforceable under this federal common law.
- Federal courts may be inclined to look to state law to interpret ambiguous plan provisions or to fashion additional federal common law. As such, plan sponsors

should ensure that non-competition provisions are well-drafted and that all terms used therein are clearly defined.

- As most plans include choice of law provisions, plan sponsors should ensure that their plan states that the plan will be interpreted in accordance with federal law and that state law will only be used to fill gaps. Plan drafters should ensure that they are familiar with the state non-competition laws of any state included in a choice of law provision in the plan.

- Although beyond the scope of this article, several cases addressing top-hat plans analyze the appropriate standard of review in top-hat plans. Plan drafters should ensure that they fully understand the standard of review in their circuit as it pertains to top-hat plans so that they can craft the best language possible to ensure the deferential standard of review.

- Additionally, plan administrators should be careful to thoroughly document their rationale in concluding that a particular activity constituted competition as these internal notes will comprise the ultimate administrative record and serve as the information that is ultimately used by the plan to defend its determination.

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