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Code to Code

Not All Retirement Plans Are Created Equal

ERISA Top-Hat Plans Constitute Property of the Bankruptcy Estate

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As many bankruptcy practitioners are aware, the Bankruptcy Code excludes Employee Retirement Income Security Act of 1974 (ERISA)[1] "qualified" retirement plans, such as employer-sponsored pensions or 401(k) plans, from the bankruptcy estate. Lacking knowledge of the intricacies of ERISA, many practitioners assume that all ERISA retirement plans are either excluded from the Code's definition of property of the estate or are exempt under applicable state or federal law.


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However, simply because a retirement plan is subject to ERISA does not shield it from creditors in bankruptcy. Therefore, it is critical that practitioners identify when an ERISA-regulated retirement plan is a nonqualified plan subject to creditors' claims. One example is a so-called "top-hat" plan. The U.S. Bankruptcy Court for the Northern District of Illinois recently ruled in *In re Jokiel* that an individual chapter 7 debtor's interest in post-petition benefit payments from a top-hat plan constituted nonexempt property of the bankruptcy estate.[2]

Top-hat plans are a special category of unfunded retirement benefits under ERISA that provide deferred compensation to a select group of management-level employees.[3] Corporations once favored top-hat plans as a mechanism to provide retirement benefits to executives in excess of Internal Revenue Code (IRC)[4] limitations on traditional retirement plans, such as 401(k) plans. Despite being regulated by ERISA, several unique features characterize top-hat plans. For example, a top-hat plan must remain unfunded, meaning that the employer cannot create a separate trust to ensure payment of benefits to plan participants. Top-hat plans are also exempt from ERISA's fiduciary requirements.[5] Courts have previously recognized that unpaid top-hat plan benefits constitute property of the estate when the employer is the debtor.[6]

Jokiel Background

Jokiel involved an insurance industry executive turned chapter 7 debtor. In the late 1990s, the debtor participated in an officer stock-loan program where he borrowed funds from his employer to purchase shares of the company's publicly traded stock, which served as collateral for the loan. Following his retirement, the debtor began receiving distributions from the employer's retirement plans. Specifically, the debtor received $212,000 annually under a top-hat plan in addition to his benefits under a "qualified" pension plan.


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The stock loan matured in 2008 during the global financial crisis, and the outstanding loan balance exceeded the value of the stock collateral by more than $2 million. The debtor filed a petition for relief under chapter 7 in which he claimed his interests in both the top-hat and pension plans as exempt.[7] The chapter 7 trustee and the debtor's former employer objected to the debtor's top-hat plan exemption.[8]

The debtor first argued that the top-hat plan was not property of the bankruptcy estate pursuant to § 541(c)(2) because it contained an anti-alienation provision that prohibited plan participants from assigning or alienating benefits and exempted the benefits from the claims of creditors. Second, the debtor argued that Illinois law exempted the top-hat plan because the plan was intended to "qualify" as a retirement plan as the term is used in the IRC.[9]

The trustee and debtor's former employer argued that § 541(c)(2) did not apply because the unfunded top-

1 Title 29, U.S. Code.
2 --- B.R. --- (Bankr. N.D. Ill. 2011), Case No. 09-27495, 2011 Bankr. LEXIS 1520 (Bankr. N.D. Ill. Apr. 21, 2011).
3 *Garratt v. Knowles*, 245 F.3d 941, 946 n. 4 (7th Cir. 2001).
4 Title 26, U.S. Code.
5 *See* ERISA §§ 201(2), 301(a)(3) and 401(a)(1); *see also Olander v. Bucyrus-Erie Co.*, 187 F.3d 599, 604 (7th Cir. 1999).
6 *See IT Group Inc. v. Bookspan (In re IT Group Inc.)*, 305 B.R. 402 (Bankr. D. Del. 2004), *aff'd*, 448 F.3d 661 (3d Cir. 2006); *see also In re Washington Mutual Inc.*, Case No. 08-12229, 2011 LEXIS 2034 (Bankr. D. Del. June 1, 2011) (finding top-hat plan participants to be general unsecured creditors and refusing to impose constructive trust in favor of plan participants even where debtor wrongfully refused to pay out lump-sum benefits prior to bankruptcy filing).
7 Because the stock loan constituted a nonconsumer debt, the means test under § 707(b) did not apply.
8 The authors represented the debtor's former employer in *Jokiel*.
9 The debtor also raised an estoppel argument that is not relevant to this article and is not addressed.

hat plan did not constitute a trust under Illinois law or a "qualified" plan under ERISA. The objectors also argued that the top-hat plan was not exempt under Illinois law because it did not—and was never intended to—qualify for favorable tax treatment under the IRC. The bankruptcy court agreed with the objectors in both instances.

Applicable Provisions of ERISA and IRC

Generally speaking, a retirement plan regulated by ERISA is required to create a trust subject to an anti-alienation provision and qualify for favorable tax treatment under the IRC. However, certain types of retirement plans are exempt from many of ERISA's substantive requirements. One such type of retirement plan is a top-hat plan.[10]

The *Jokiel* court recognized that, unlike a standard retirement plan, one of the express purposes of a top-hat plan is to provide deferred compensation in excess of ERISA and IRC limitations that are applicable to "qualified" plans.[11] To accomplish this goal, ERISA requires that all top-hat plans be "unfunded."[12] Federal courts define the term "unfunded" under ERISA to mean that the deferred compensation paid under a top-hat plan is subject to the claims of an employer's general unsecured creditors in bankruptcy.[13] In contrast, "[t]he essential feature of a funded plan is that its assets are segregated from the general assets of the employer and are not available to general unsecured creditors if the employer becomes insolvent."[14] Therefore, top-hat plan participants are paid from a plan sponsor's "general assets" as payments are due, not from a trust or other segregated fund. Not surprisingly, courts recognize that "[i]f a plan fits the 'top-hat' exclusion, ERISA does not impose a trust on the plan's funds."[15] Federal courts have recognized that top-hat plans are enforceable as unilateral contracts, not trusts.[16]

Despite the requirement that top-hat plans remain unfunded, a top-hat plan sponsor may create a so-called "rabbi" trust in which the plan sponsor deposits sufficient funds to cover its obligations under the plan.[17] The unfunded status of a top-hat plan is not compromised by creation of a rabbi trust so long as (1) the plan participants have no interest in the rabbi trust assets, (2) the rabbi trust assets remain part of the plan sponsor's general assets and (3) the rabbi trust assets remain subject to the claims of the plan sponsor's unsecured creditors.[18] Such an arrangement requires the plan sponsor to pay any taxes due from the income generated by the trust assets.[19] The top-hat plan in *Jokiel* did not utilize a rabbi trust, so the bankruptcy court did not address this issue.

When a plan beneficiary seeks bankruptcy protection, his or her right to receive payments constitutes property of the estate that will not be exempt in most states.

The court recognized that top-hat plans must remain unfunded and are not subject to ERISA § 206(d), which requires retirement plans to contain a provision preventing plan participants from alienating or assigning benefits.[20] Thus, despite the fact that the top-hat plan contained an anti-alienation provision, the court found that it was not required by or even enforceable under ERISA.[21]

The court also found that the top-hat plan was not a "qualified" retirement plan under the IRC.[22] Rather, the court concluded that a top-hat plan (1) is specifically designed to provide compensation that exceeds the maximum amount allowed under IRC §§ 401(a)(16), 401(a)(17) and 415, (2) fails to satisfy the minimum participation requirements of IRC § 401(a)(3) and (3) impermissibly discriminates in favor of highly compensated employees in contravention of IRC § 401(a)(4). A top-hat plan may also constitute a nonqualified plan by failing to comply with IRC § 401(a)(13), which requires the presence of an anti-alienation provision.

Property of the Estate

Pursuant to Bankruptcy Code § 541(a), the bankruptcy estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case."[23] Section 541(c) plays a critical role in determining whether a retirement plan is property of the bankruptcy estate. This section generally provides that "an interest of the debtor in property becomes property of the estate…notwithstanding any provision in an agreement…or applicable nonbankruptcy law that restricts or conditions transfer of such interest by the debtor."[24] However, § 541(c)(2) contains an exception to the general rule and provides that "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title."[25] In *Jokiel*, the debtor argued that the anti-alienation provision in the top-hat plan was enforceable under § 541(c)(2).

The court began its analysis of § 541(c) by noting that an anti-alienation provision is not enforceable in bankruptcy unless it falls within the exception contained in § 541(c)(2).[26] The court found that § 541(c)(2) was commonly understood to exclude a debtor's beneficial interest in a "spendthrift trust" from becoming property of the bankruptcy estate and that state law generally sets forth the requirements of a spendthrift trust.[27]

Most states, including Illinois, recognize a spendthrift trust to be an enforceable trust created to provide funding for the maintenance of another while limiting the beneficiary's ability to access the funds held in trust in order to protect the beneficiary from his or her own improvidence.[28] Under Illinois law, a spendthrift trust must comply with the following requirements: (1) the trust must contain an anti-alienation provision; (2) the trust must not be self-settled (meaning that the settlor may not be the beneficiary); and (3) the beneficiary must not control the property of the trust.[29] Furthermore, the existence of a valid trust is a prerequisite for the existence of a spendthrift trust.[30] Creation of an express trust under Illinois law requires that "the settlor presently and unequivocally make a disposition of property by which he [or she]

10 *Jokiel*, 2011 LEXIS 1520, at *2.
11 *Id.*
12 *Garratt*, 245 F.3d at 946 n. 4.
13 *IT Group*, 305 B.R. at 407.
14 *Miller v. Heller*, 915 F.Supp. 651, 657-58 (S.D.N.Y. 1996) (citing *Northwestern Mutual Life Insurance Co. v. Resolution Trust Corp.*, 848 F.Supp. 1515 (N.D. Ala. 1994)).
15 *IT Group*, 305 B.R. at 407.
16 *Koenig v. Waste Management Inc.*, 76 F.Supp.2d 908, 914 (N.D. Ill. 1999). The distinction between trusts and contracts is also recognized under Illinois law. *See Kilgore v. The State Bank of Colusa*, 372 Ill. 578, 584-85 (1939).
17 *Washington Mutual*, 2011 LEXIS 2034, at *5-6.
18 *Id.*
19 *Resolution Trust Corp. v. MacKenzie*, 60 F.3d 972, 974 (2d Cir. 1995).
20 *Jokiel*, 2011 LEXIS 1520, at *2; *see also IT Group*, 305 B.R. at 407 (stating that "[t]op-hat plans are a special breed of ERISA plans that are excluded from the substantive provisions of ERISA") (citing ERISA §§ 201(2), 301(a)(3) and 401(a)(1)).
21 *Jokiel*, 2011 LEXIS 1520, at *2.
22 *Id.*
23 *Id.* at § 541(a)(1).
24 *Id.* at § 541(c)(1)(A).
25 *Id.* at § 541(c)(2).
26 *Jokiel*, 2011 LEXIS 1520, at *5-6.
27 *Id.*
28 *See, e.g., In re Dagnall*, 78 B.R. 531, 534 (Bankr. C.D. Ill. 1987).
29 *Schechter v. Balay (In re Balay)*, 113 B.R. 429, 437 (Bankr. N.D. Ill. 1990).
30 *In re Griffin*, 2009 Bankr. LEXIS 4620 (Bankr. S.D. Ill. 2009) (finding that annuity purchased pursuant to personal-injury settlement was not technical trust under Illinois law and therefore could not be spendthrift trust under Illinois law for purposes of § 541(c)(2)).

divests himself of the full legal and equitable ownership thereof."[31] Illinois law also requires that there must be a particular intent to confer benefits through a *trust* and not through some related or similar device.[32]

In *Jokiel*, the bankruptcy court noted that the term "trust" is not defined in the Bankruptcy Code. Therefore, the court looked to the Restatement (Third) of Trusts for the definition and requirements. The court found that the "unfunded" top-hat plan lacked a trust *res*, which prevented the creation of a trust.[33] Accordingly, the court ruled that the absence of a trust rendered § 541(c)(2) inapplicable with respect to Illinois law.

Next, the court examined whether the top-hat plan was excluded from the bankruptcy estate pursuant to § 541(c)(2) because it was a "qualified" plan under ERISA. In *Patterson v. Shumate*, the U.S. Supreme Court clarified that § 541(c)(2)'s reference to "applicable nonbankruptcy law" included federal law as well as state law.[34] *Patterson* addressed whether the retirement plan at issue satisfied all substantive legal requirements under ERISA.[35] In particular, that retirement plan created a trust that contained an anti-alienation provision as required by ERISA § 206(d)(1) and that qualified for favorable tax treatment under the IRC.[36] The Court ruled that ERISA constituted applicable nonbankruptcy law for purposes of § 541(c)(2) and that ERISA-qualified plans are excluded from becoming property of the bankruptcy estate pursuant to § 541(c)(2).[37]

However, the Court did not clearly define what constituted a qualified plan. As a result, courts have disagreed on the definition of "qualified" under *Patterson*.[38] This issue is critically important in determining whether an ERISA plan is protected from creditors in bankruptcy. In *Matter of Baker*, the Seventh Circuit determined that ERISA-qualified means that a retirement plan contains an anti-alienation provision that is required by ERISA § 206(d)(1).[39] Accordingly, the *Jokiel* court concluded that § 541(c)(2) did not exclude the top-hat plan from the bankruptcy estate because the plan lacked a trust and was not ERISA-qualified on account of the inapplicability of ERISA's anti-alienation requirement.[40]

State Law Exemptions

The bankruptcy court addressed whether the top-hat plan was exempt under Illinois law,[41] which provides that a retirement plan is exempt if the plan "is intended in good faith to qualify as a retirement plan under applicable provisions of the Internal Revenue Code of 1986, as now or hereafter amended."[42] This provision appears intended to protect those plans that would be exempt, but for an inadvertent technical deficiency. The debtor argued that this Illinois exemption should be construed broadly so as to protect any asset that constitutes a retirement plan as the term is used in the IRC regardless of whether such asset qualifies for preferential tax treatment under the IRC.

The court rejected the debtor's broad reading of Illinois law and found that the Illinois exemption only applied to retirement plans that were intended to qualify for preferential tax treatment under the IRC.[43] The court noted that the debtor's proposed interpretation of the statute could render substantially all of a debtor's assets exempt based on a debtor's subjective intent and would therefore undermine Illinois' exemption scheme.[44] Having found that the top-hat was not a "qualified" retirement plan under the IRC, the only remaining issue for the court was whether the top-hat plan was exempt because it was *intended* to qualify for preferential tax treatment under the IRC. The court noted that the top-hat plan contained provisions indicating that it was not intended to be a "qualified" plan under the IRC and ruled that the top-hat plan was not exempt under Illinois law.[45]

Conclusion

The current economic climate may result in more top-hat plan participants and sponsors seeking bankruptcy protection. Therefore, bankruptcy practitioners should be aware that although top-hat and other types of retirements plans, such as excess-benefit plans, are regulated under ERISA, they are exempt from many of ERISA's substantive requirements. In bankruptcy cases of plan sponsors, these plans give rise to unsecured claims. When a plan beneficiary seeks bankruptcy protection, his or her right to receive payments constitutes property of the estate that will not be exempt in most states. ■

31 *Kavanuagh v. Dobrowolski*, 86 Ill. App. 3d 33, 40 (1st Dist. 1980).
32 *Eychaner v. Gross*, 202 Ill. 2d 228, 255 (2002).
33 *Jokiel*, 2011 LEXIS 1520, at *5-6.
34 504 U.S. 753, 758 (1992).
35 *Id.* at 755.
36 *Id.*
37 *Id.* at 760.
38 *See, e.g., In re Gaudette*, 240 B.R. 649, 653 (Bankr. D. N.H. 1999) (noting as many as four possible interpretations of definition of "ERISA qualified").
39 114 F.3d 636, 638 (7th Cir. 1997).
40 *Jokiel*, 2011 LEXIS 1520, at *6-7.
41 Bankruptcy Code § 522(b)(3)(A) permits states, such as Illinois, to opt out of the federal exemption scheme in favor of state law exemptions. *See* 735 ILCS 5/12-1201.
42 *See* 735 ILCS 5/12-1006(a).
43 *Jokiel*, 2011 LEXIS 1520, at *3.
44 *Id.*
45 *Id.* at 4.