

## **Creditors' Rights to Top-Hat Plan Benefits**

**By Louis A. Cannizzaro**

As more estate planning vehicles and financial products (such as pay-on-death accounts, joint accounts, revocable lifetime trusts, and various forms of retirement plans) become available and widely used, estates attorneys often find that the value of a decedent's assets that were individually owned or left to the decedent's estate (*i.e.*, the "probate assets") are greatly exceeded by the value of the assets that pass to a surviving joint owner or a named beneficiary by operation of law (the "non-probate assets"). As a result, the decedent's creditors cannot obtain full payment of their debts from the decedent's probate estate. Those creditors are often prevented from obtaining payment from the survivor benefits of the decedent, if any, in executive retirement plans, often called "Top-Hat Plans."

### **I. Introduction**

Section 1811 of the New York Surrogate's Court Procedure Act establishes the following priority for the payment of debts from probate assets:

- (1) First, funeral expenses, subject to the payment of administration expenses, which generally include attorney fees, executor's commissions, and estate and fiduciary income taxes.
- (2) Second, any debts entitled to priority under relevant federal or New York law, such as unpaid federal personal income taxes.<sup>1</sup>
- (3) Third, taxes assessed on property of the decedent prior to death.
- (4) Fourth, judgments docketed and decrees entered against the decedent prior to death.
- (5) Fifth, all other debts owed by the decedent, to be satisfied pro rata if the estate is insolvent.

No similar rules govern the priority of payments to creditors from non-probate assets, other than those that give priority to debts secured by such property, such as in the case of

mortgages on real property passing by operation of law.<sup>2</sup>

Consider the following scenario: a New York resident passes away owning only a small bank account in her individual name, a modest amount of investments in her individual retirement account (IRA), and a much more valuable interest in an unfunded, nonqualified plan managed by her former employer primarily for the purpose of providing deferred compensation to a select group of management or highly compensated employees, often referred to as a Top-Hat Plan. Suppose the assets in the decedent's individual bank account are insufficient to satisfy the decedent's creditors.<sup>3</sup>

This scenario raises two issues. May a creditor of the decedent compel the Top-Hat Plan to pay the creditor the participant's survivor benefits? May the creditor garnish payments of plan benefits to the participant's beneficiary?

The responses depend upon which state's law controls the creditor's rights, which need not be New York if the Top-Hat Plan is subject to another state's law, as is often the case when a decedent worked in another state. This article will analyze the relevant case law and statutes as they apply to plans subject to New York law.

## **II. Applicable New York State Law**

Several New York State laws may insulate interests in a Top-Hat Plan from the claims of a plan participant's creditors.

Perhaps the most prevalent New York statute governing protection from creditors in New York is Section 5205 of New York's Civil Practice Law and Rules (CPLR), which specifically provides that certain personal property is exempt from being applied to the satisfaction of money judgments. Civil Practice Law and Rules 5205(c)(1) provides, with limited exceptions, for the protection of "all property while held in trust for a judgment debtor, where the trust has been

created by, or the fund so held in trust has proceeded from, a person other than the judgment debtor.” Civil Practice Law and Rules 5205(c)(2) goes on to specify that such property held “in trust” under CPLR 5205(c)(1) includes all manner of “trusts, custodial accounts, annuities, insurance contracts, monies, assets or interests established as part of, and all payments from” retirement assets that are established and maintained under specified provisions of the Internal Revenue Code of 1986, as amended (the “Code”).

By tying the CPLR protections for retirement benefits to specific sections of the Code, without any specific reference to the Employee Retirement Income Security Act, as amended (ERISA), concerns about ERISA preemption are quelled. United States Supreme Court decisions discussed below held that specific references to ERISA in state statutes will cause the statutes to be preempted, regardless of the nature of the reference.

The Code provisions referenced by CPLR 5205(c) include Code §§ 401, 403, 408, 408A, and 457. Code §§ 401(a) (tax-qualified plans funded with trusts), 403(a) (tax-qualified plans funded with annuities), 408 (traditional IRAs funded with trusts, annuities or custodial accounts), and 408A (Roth IRAs funded with trusts, annuities or custodial accounts) require plans to be funded. Thus, those provisions are inapplicable to Top-Hat Plans because by definition such plans are not funded. However, Code § 457 governs Top-Hat Plans sponsored by tax-exempt entities, such as many schools and hospitals, and by state and local governments and any of their agencies. It does not govern plans sponsored by taxable private entities, such as trades or businesses.

Civil Practice Law and Rules 5205(c)(2) provides specifically that benefits from a retirement plan “that satisfy[y] the requirements of section 457 of the Internal Revenue Code” are protected. Two sets of plans satisfy the requirements of Code § 457. The first are eligible

deferred compensation plans under Code § 457(b), whose deferrals are subject to certain annual limits, similar to the contribution limits of tax-qualified plans.<sup>4</sup> The second are Code § 457(f) plans, which are deferred compensations arrangements that do not satisfy the Code § 457(b) requirements.

This debtor protection continues after death, as New York provides strong debtor protections for many testamentary substitutes. As illustrated by the Broome County Surrogate's Court decision in *In re Estate of King*, by virtue of either New York statute or case law:

[V]irtually every type of retirement plan is exempt from the claims of a decedent's creditors. Anti-alienation applies to ERISA plans (29 USC § 1056 (b)), New York State employees' retirement plans (Retirement & Social Security Law § 110), New York State teachers' retirement plans (Education Law § 524), Individual Retirement Accounts (CPLR 5205 (c)), Federal Thrift Savings Plans (*Matter of Gallet*), and life insurance and annuities (*Matter of Clotworthy* and Insurance Law § 3212).<sup>5</sup>

Although the Court in *King* did not deal specifically with a Top-Hat Plan, it extended creditor protections to the decedent's Code § 403(b) retirement plan benefit at issue, which are not subject to CPLR 5205(c). That benefit may be regarded as derived from both an annuity contract and from a retirement plan. Thus, the Court held there was "no logical reason" why it should not be similarly exempt from the claims of the participant's creditors after death on either of those two grounds.<sup>6</sup> The Court found statutory support for this position in New York Estates, Powers and Trusts Law (EPTL) 13-3.2, which protects the beneficiaries of a participant's retirement plan or annuity plan from the claims of the participant's creditors.<sup>7</sup> One may argue similarly that a participant's survivor benefits from any Top-Hat Plan that is a retirement plan are protected from claims of the participant's creditors.<sup>8</sup>

There is an additional argument that may be used to protect both the participant and the beneficiaries of the participant's Top-Hat Plan from the participant's creditors even though the

plan is not a Code § 457 plan. The purpose of CPLR 5205(c)(2) is to expand the types of assets that are considered to be “held in trust” for purposes of CPLR 5205(c)(1). It may be argued that some Top-Hat Plans are “held in trust” under subsection (c)(1) even though the plans are considered unfunded, and therefore protected from a debtor’s creditors during the participant’s life and after death.

While no New York courts appear to have considered whether CPLR 5205(c)(1) applies to Top-Hat Plans, a federal court has ruled on the application of the statute to trusts that are not tax-qualified retirement plan trusts.

In *In re Quackenbush*,<sup>9</sup> the Bankruptcy Court for the Southern District of New York was asked to rule whether a debtor’s Code § 529 college savings plan was protected from his creditors by virtue of it being a plan held “in trust” within the meaning of CPLR 5205(c)(1). In finding that the plan benefits should be used to satisfy the debtor’s creditors, the Court examined whether the account could be considered to be “held in trust” for purposes of the statute by examining the nature of the relationship between the debtor and the custodian of the 529 plan established by the Uniform Gifts to Minors Act (UGMA). The court noted that New York cases found that the relationship between a custodian and a Code § 529 plan beneficiary was not one of a fiduciary nature, and that such plans are essentially a statutory method of making inter-vivos gifts of securities or money to minors, who would become the legal and equitable owner of the plan upon their reaching the age of majority. Accordingly, the court found that such plan benefits were not protected by CPLR 5205(c)(1).

While the debtor’s argument in *In re Quackenbush* failed, the decision does not preclude the argument that CPLR 5205(c)(1) is applicable if a separate trust (often called a “Rabbi trust”<sup>10</sup>) is established to partially fund the Top-Hat Plan. While Rabbi trusts, by design, do not

operate to protect against claims of an employer's general creditors, the fiduciary relationship that such trusts establish between their trustees and plan beneficiaries would seem to provide a basis for the application of CPLR 5205(c), and therefore defeat the claims of a participant's creditors.<sup>11</sup> Such trusts are described more fully in Rev. Proc. 92-64, 1992-2 C.B.

### **III. Applicable Federal Law**

Several federal statutes may limit the ability of a participant's creditors to obtain an interest in the participant's benefits from Top-Hat Plans.

Title III of the Federal Consumer Credit Protection Act (CCPA)<sup>12</sup> generally limits the garnishment of earnings in any workweek or pay period to 25 percent of disposable earnings.<sup>13</sup> Earnings are defined as "compensation paid or payable for personal services, whether denominated as wages, salary, commission, bonus or otherwise, and includes periodic payments pursuant to a pension or retirement program."<sup>14</sup>

Using this broad definition, periodic payments from Top-Hat Plans appear to qualify as "earnings" for purposes of the CCPA.<sup>15</sup> Although there are no cases addressing payments from Top-Hat Plans, it appears that the statute may protect 75% of the distributions from such plans from garnishment.<sup>16</sup>

This protection, however, only applies to payments as they are paid from Top-Hat Plans, and does not provide protection to a participant's total interest in such plans. Accordingly, one must look elsewhere for further sources of potential protection at the federal level.

### **IV. ERISA**

The primary federal legislation that governs entitlements to retirement benefits is the ERISA,<sup>17</sup> which was enacted by Congress to protect the interests of employees and their beneficiaries in employee benefit plans. The Code only determines the tax treatment of pension

benefits, contributions, and plans, but not benefit entitlements. Plans that ERISA governs must disclose plan information to beneficiaries,<sup>18</sup> and plan fiduciaries must satisfy demanding standards of conduct.<sup>19</sup> One of the most important ERISA provisions is the requirement that pension plans that cover a broad cross section of employees, other than Savings Incentive Match Plans for Employees of Small Employers and simplified employee plans, must provide a participant's spouse with survivor benefits.<sup>20</sup> Such plans are thus often called Spousal Survivor Benefit Plans, which do not include Top-Hat Plans (which do not cover a broad cross-section of employees). Spousal Survivor Benefit Plans must prevent a participant from freely selling, transferring, or assigning her interest in the plan to another person.<sup>21</sup>

The ERISA preemption provision provides that ERISA shall supersede any state laws that "relate to" employee benefit plans that are governed by its terms.<sup>22</sup> Whether specific state laws "relate to" an employee benefit plan under ERISA, and would therefore be superseded, has been the subject of several United States Supreme Court decisions and many articles.

The Supreme Court discussed the rights of a participant's creditor to compel an ERISA plan to pay the participant's benefit to a creditor in *Mackey v. Lanier Collection Agency & Service, Inc.*<sup>23</sup> In particular, a collection agency sought to enforce an order issued by the Georgia state courts to compel a participant's ERISA vacation plan to pay the participant's debt on behalf of the participant when the plan would otherwise make benefit payments to the participant. The Court first found that ERISA preempted Georgia's state level garnishment provision that specifically referenced, and prohibited attachment of judgments to, ERISA employee benefit plans. The Court then found that ERISA did not preempt the more general provisions of Georgia's garnishment law (which did not specifically reference ERISA) from being used to enforce debts against the participant's interests in an ERISA plan that was not a Spousal

Survivor Benefit Plan, such as the vacation plan at issue.

*Mackey* illustrates the Supreme Court's position that state laws that specifically reference ERISA plans "relate to" them for purposes of preemption, regardless of the state statute's actual effects on ERISA plans. The *Mackey* decision permitting state-law garnishments of an ERISA plan, however, is somewhat at odds with later decisions, in which the Supreme Court found that ERISA's benefit entitlement provisions preempted state laws to the contrary. For example, in *Kennedy v. Plan Admin. of DuPont Sav. and Inv. Plan.*,<sup>24</sup> a decedent designated his wife as the beneficiary of his savings and investment plan, which was an "employee pension benefit plan" subject to ERISA. Following this designation, the couple divorced, and the wife's interest in the plan was "divested" pursuant to a state divorce decree. The decedent, however, failed to replace his wife as the plan's designated beneficiary. The decedent's daughter and executor argued that the wife's divestiture caused her beneficiary interest in the pension plan to be extinguished, which implied that under the plan terms the benefits were payable to the decedent's estate. The Court found that the decedent's plan, which was subject to ERISA, was required to pay benefits pursuant to its own terms, which did not provide for any such benefit extinguishment, and accordingly found that the plan proceeds were properly payable to the decedent's ex-wife.<sup>25</sup> The Court also ruled that federal common law did not supersede plan entitlements and declared it had previously held that conflicting state laws would also not supersede plan entitlements.<sup>26</sup>

The inconsistency between *Mackey* and *Kennedy* is best explained by the recognition that *Mackey* did not discuss the ERISA entitlement of participants to benefits pursuant to the terms of the plan. This was the focus of *Kennedy*, and discussed explicitly in the Court's earlier 1997 post-*Mackey* preemption decision of *Boggs v. Boggs*.<sup>27</sup> In *Boggs*, the Supreme Court held that ERISA preempted a Louisiana state law which would have allowed the decedent's first spouse,

who predeceased him, to dispose of her community property interest in the decedent's undistributed pension plan benefits under her Will. The Court found that allowing a predeceased first spouse to dispose of the ERISA plan benefits of her husband, the participant, via Will would directly conflict with "ERISA's solicitude for the economic security of surviving spouses."<sup>28</sup> Congress approved the Retirement Equity Act of 1984 (which modified ERISA) in order to improve the protection of surviving spouses in significant respects, including, among other things, ensuring a stream of income to surviving spouses through the qualified joint and survivor annuity provisions.<sup>29</sup> Accordingly, the state law was held to be preempted by ERISA.<sup>30</sup>

Moreover, the decision to find that ERISA preempts the explicit exemption of ERISA plans from the Georgia garnishment law is based on what some have argued is a flawed interpretation of prior Supreme Court case law.<sup>31</sup> Before *Mackey*, the Court had not held that a state law was preempted based solely on a mere reference to ERISA, yet the *Mackey* Court arguably misconstrued the holdings in certain cases (such as *Shaw v. Delta Air Lines, Inc.*<sup>32</sup>) to find that *any* explicit reference in a state law to an ERISA plan results in the preemption of that law, regardless of the law's actual effect on the plan itself.

Despite this, at least one federal court has applied to Top-Hat Plans *Mackey's* holding that ERISA does not preempt the application of general state garnishment statutes to ERISA plans other than Spousal Survivor Benefit Plans. In *Sposato v. First Mariner Bank*,<sup>33</sup> the United States District Court of Maryland found that the defendant, a creditor of the plaintiff, could garnish the plaintiff's benefit payments from a Top-Hat Plan. It based its ruling primarily on the assertions that: (1) ERISA's anti-alienation provision does not apply to Top-Hat Plans; and (2) Maryland's general garnishment statute did not specifically reference ERISA, nor violate any of its other provisions. Accordingly, the court held that ERISA did not preempt the garnishment of

the plaintiff's benefit payments from the Top-Hat Plan.

In *Sposato*, however, the defendant sought to use Maryland law to garnish-benefits as they became due and payable to the plaintiff. However, the Court stated that the law allowed the collection of debts against Top-Hat Plan benefits prior to those benefits becoming due and payable. The court did not consider the ability to garnish survivor benefits under Maryland law, which would be more applicable in the context of estate administrations.

In light of this uncertainty regarding the application of federal law, it is useful to determine whether state law limits the ability to collect debts against a participant's Top-Hat Plan benefits. For example, under New York law, the results would be different. Under CPLR 5205 and EPTL 13-3.2, as discussed above, the participant's creditor likely could not garnish the survivor benefits of a Top-Hat Plan that is a retirement plan before or after the benefits become due and payable to a beneficiary. In contrast, as discussed above, the creditor during the participant's life may use a different state's garnishment law (such as the one in Maryland) to garnish the participant's lifetime benefits as they become payable to her.

## **V. Conclusion**

Under New York Law, there is strong support for the conclusion that creditors may not generally obtain the participant's survivor benefits from a Top-Hat Plan that is a retirement plan. This is the case whether the participant's creditors seek to enforce a judgment against the plan itself, against the plan's benefit payments to the beneficiary, or against the beneficiary. There is similar and specific protection for the participant during the participant's life if the plan is sponsored by a tax-exempt private entity, or by a state or local government or an agency of such a government.

However, the extent of the debtor protection available for interests in Top-Hat Plans

sponsored by private entities other than tax-exempt entities is quite ambiguous. The results may differ if laws from other states determine the creditor-debtor rights to the Top-Hat Plan benefits at issue, such as for a participant who worked in another state.

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<sup>1</sup> 31 U.S.C. § 3713(a)(1)(b).

<sup>2</sup> See generally, Timothy M. Ferges & Dana L. Mark, *In the Red: Decedent's Creditors and Non-Probate Assets*, NYSBA TRUSTS AND ESTATES LAW SECTION NEWSLETTER, Spring 2015 at 4 (discussing the rights of a decedent's creditors to the decedent's non-probate assets).

<sup>3</sup> As discussed below, IRA survivor benefits are not generally available to pay the decedent's creditors.

<sup>4</sup> See, e.g., I.R.C. § 401(a)(16), which governs plans qualified under I.R.C. § 401(a).

<sup>5</sup> 764 N.Y.S.2d 519, 523 (Sur. Ct., Broome Co. 2003) (holding that creditors may not compel payment of their debts from non-probate assets that included a life insurance policy, a teacher's retirement system death benefit, and a 403(b) account).

<sup>6</sup> *Id.*

<sup>7</sup> See *id.* at 522. More specifically, N.Y. EPTL 13-3.2(a) provides that the rights of beneficiaries to receive distributions from all manner of trusts, retirement assets, annuities, etc. "shall not be impaired or defeated by any statute or rule of law governing the transfer of property by will, gift or intestacy." This does not apply to transfers that were intended as an attempt defraud creditors, which is prohibited under Article 10 of the Debtor and Creditor Law (see EPTL 13-3.2(b)).

<sup>8</sup> See also Timothy M. Ferges and Dana L. Mark, *In the Red: Decedent's Creditors and Non-Probate Assets*, NYSBA Trusts and Estates Law Section Newsletter, Spring (2015) at 2 (discussing EPTL 13-3 more extensively).

<sup>9</sup> 339 B.R. 845 (S.D.N.Y. 2006).

<sup>10</sup> The name 'Rabbi trust' descends from a determination by the Internal Revenue Service concerning an irrevocable trust established for a rabbi by his congregation. See I.R.S. Priv. Ltr. Rul. 8113107 (December 31, 1980).

<sup>11</sup> While there appear to be no reported decisions applying CPLR 5205 specifically to a Rabbi trust, its application in such instances is consistent with existing case law that Rabbi trusts are generally subject to the grantor's (i.e., the employer's) creditors in bankruptcy. See, e.g., *Collins & Aikman Corp. v. Northern Trust Bank of Cal., N.A.* (*In re Collins & Aikman Corp.*), No. 05-55927, 2006 WL 2310798 (Bankr. E.D. Mich Aug. 9, 2006).

<sup>12</sup> 15 U.S.C. §§ 1671 *et. seq.*

<sup>13</sup> 15 U.S.C. § 1673(a).

<sup>14</sup> 15 U.S.C. § 1672(a).

<sup>15</sup> See e.g., *United States v. Lee*, 659 F.3d 619 at 621 (7th Cir. 2011) (holding that 75% of 401(k) plan benefit payments are protected). Cf. *Sposato v. First Mariner Bank*, 2013 U.S. Dist. LEXIS 111824 at 13-14 (D. Md. March 29, 2013) (court asked parties to brief the issue).

<sup>16</sup> See, e.g., *Lee*, 659 F.3d at 621-22.

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<sup>17</sup> The Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified as amended in scattered sections of 29 U.S.C.).

<sup>18</sup> ERISA §§ 101-111.

<sup>19</sup> ERISA §§ 401-414.

<sup>20</sup> ERISA §§ 201 and 205.

<sup>21</sup> ERISA § 206(d).

<sup>22</sup> ERISA § 514(a).

<sup>23</sup> 486 U.S. 825 (1988).

<sup>24</sup> 555 U.S. 285 (2009).

<sup>25</sup> *Id.* at 299-301.

<sup>26</sup> *Id.*, at 302-04.

<sup>27</sup> 520 U.S. 833 (1997).

<sup>28</sup> *Id.* at 843.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.* at 843-844.

<sup>31</sup> See, e.g., Albert Feuer, *When Do State Laws Determine ERISA Plan Benefit Rights?*, 47 J. MARSHALL L. REV. 145, 270-73 (Fall 2013), available at <http://ssrn.com/abstract=2440008> (last visited December 28, 2015).

<sup>32</sup> 463 U.S. 85 (1983).

<sup>33</sup> 2013 U.S. Dist. LEXIS 45806 (D. Md. March 29, 2013).