U.S. Department of Labor

2020 ERISA Advisory Council on Employee Welfare and Pension Benefit Plans

Examining Top Hat Plan Participation and Reporting

Public Hearing, October 22, 2020, 4:15 p.m. – 5:15 p.m.

Witness Testimony: Barry K. Downey, Co-Founder, Smith & Downey, P.A.

Barry K. Downey
Smith & Downey, P.A.
320 E. Towsontown Blvd., Suite 1 East
Baltimore, Maryland 21286
(410) 321 9351 (Direct Line)
(410) 321 6270 FAX
bdowney@smithdowney.com
www.smithdowney.com

I began my career in this area of the law working for the law firm of Piper & Marbury (now DLA Piper) in 1983 as a full time law clerk/paralegal through two years of law school. After law school, I worked with Piper & Marbury for several years until 1992, when I and two other attorneys from that firm established the law firm of Smith & Downey. Throughout my over 35 years of experience in this area of the law, I have worked extensively with top hat plans, including the design, development and implementation of a broad spectrum of programs for executive deferred compensation. During that time, I have developed, written, and implemented—or advised clients with respect to—several thousand executive compensation programs. Those clients include top hat plan sponsors, top hat plan service providers (e.g., consultants and advisers who sell products or services, third party administrators, trustees), and participants in top hat plans.

The stated topic for these hearings is "Examining Top Hat Plan Participation and Reporting", and is in response to the January 2020 report issued by the U.S. Government Accountability Office (GAO). The GAO Report recommended that the DOL determine (1) whether its reporting requirements for top hat plans should be modified to provide additional information, (2) whether employers are inappropriately including rank-and-file employees in top hat plans, and (3) whether the DOL should provide specific instructions for companies to follow to correct eligibility errors that occur when rank-and-file employees are found to be participating in top hat plans. The Council's stated objective for these hearings "is to determine whether guidance is needed to define a 'select group of management or highly compensated employees' and whether enhanced reporting would be helpful and appropriate".

I do not believe that there has been any testimony before the Council that indicates any inappropriate inclusion of rank-and-file employees in top hat plans. Personally, I have never seen any example of that occurring.

Although I will be commenting on this second question from the GAO report, my focus will be to address the two questions in the stated objective of this Council.

1. Is guidance needed to define a "select group of management or highly compensated employees"?

This guidance may be needed if (1) employers are inappropriately including rank-and-file employees in top hat plans and additional protections are necessary for top hat plan participants, (2) there is uncertainty or confusion regarding the determination of a select group of management or highly compensated employees, (3) guidance would provide clarity or certainty to these determinations, or (4) a lack of guidance inhibits the ability of the DOL or affected employees to enforce the law.

It is my view that guidance is not needed for any of these, or any other, reasons.

(1) Are employers inappropriately including rank-and-file employees in top hat plans?

In my over 35 years of experience in this area, I have not seen even one instance of a client including or attempting to include rank-and-file employees in a plan that was intended to be a top hat plan. In the over 45 years since the enactment of ERISA, I have found only one DOL Advisory Opinion and only a couple of federal court decision that determined the plan at issue was not a top hat plan because of the broad range of salaries and positions of employees covered by the plan.

(2) Is there uncertainty or confusion regarding the determination of a select group of management or highly compensated employees?

Attached to my written testimony is an excerpt from the book I co-author, the *Nonqualified Deferred Compensation Answer Book*. As described in this excerpt, shortly after the enactment of ERISA in 1974, the DOL started issuing guidance (in the form of Advisory Opinions) on top hat plans. In 1975, three of these opinions concluded that the plans at issue were top hat plans. The next DOL opinion on the topic was in 1985, when the DOL concluded that the plan at issue was not a top hat plan (the plan at issue covered individuals earning as little as $12,124 a year and holding positions such as department foreman). In early 1988, the DOL confirmed that these four Advisory Opinions should not be relied upon to determine top hat plan status.

In 1990, in DOL Advisory Opinion 90-14A, the DOL provided its view of the rationale behind Congress's enactment of the top-hat exemption. According to that opinion, it is the view of the DOL that in providing relief for top hat plans from the broad remedial provisions of ERISA, Congress recognized 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, and, therefore, would not need the substantive rights and protections of Title I. This continues to be the DOL's position.

The DOL has indicated that if regulations ultimately are issued, the regulations likely will discuss the terms "unfunded", "select group", "management", "highly compensated", "or", and "primarily", as used in ERISA to describe a top hat plan. It is not clear whether the DOL would design the regulations to affect existing plans or to apply only to plans established after the date the regulations are issued. I would argue that any regulations should be effective prospectively only and should not be applied to existing plans and existing participants in those plans.

Beginning in the early 1980's, the federal courts began to hear cases that included the issue of top hat plans. However, some courts have rejected the DOL's view and concluded that individual bargaining power is not relevant to a determination of top hat status.

In almost every instance, these cases have been brought by participants in the plans who were not rank-and-file employees, and no rank-and-file employees were eligible to participate in the plan. Rather, the plaintiffs were the executive employees who participated in the plan, who were not paid their benefits (in accordance with the plan terms), and who sued the employer and argued that ERISA's top hat exemption did not apply to the plan. The plaintiffs did not argue that the plans were not top hat plans because rank-and-file employees were allowed to participate in the plan. Rather, any argument that the plan coverage was overbroad was the argument that the plans were not top hat plans because too many management and highly compensated employees were allowed to participate in the plan. These lawsuits were attempts to circumvent the plan terms and impose ERISA's more liberal qualified retirement plan requirements (or state contract law) on the plan which would have resulted in the payment of benefits that had been forfeited under the terms of the plan. In almost every instance, the federal courts have determined that the plans at issue were top hat plans under ERISA.

In a couple of rare exceptions to this typical fact pattern:

Roberts v. Fearless Farris Service Stations, Inc. [43 Employee Benefits Cas. (BNA) 1577 (D. Idaho Feb. 6, 2008)] found that a plan whose coverage extended to administrative staff, payroll clerks, truck drivers, and maintenance workers was not a top-hat plan.

Starr v. JCI Data Processing, Inc, 757 F. Supp. 390 (D.N.J. 1991), *vacated by, in part on reconsideration by and summary judgment granted by* 767 F. Supp. 633 (D.N.J. 1991)] found that a plan that covered only employees who had worked for the employer's former parent company (consisting of nonsupervisory clerical positions (37.5 percent), line supervisors (25 percent), and upper management (37.5 percent)), whose salaries ranged from $12,000 to $336,000, was not for the benefit of a select group. The plan had not been set up as a top hat plan, but the employer argued in the court proceedings (for the first time and without success) that the plan was a top hat plan.

For the past two decades, top hat plans have been designed, implemented and operated under this guidance from the DOL and the federal courts. There is very little, or no, uncertainty or confusion regarding the determination of a select group of management or highly compensated employees. The following is a brief outline of the current standards that I recommend be followed each year when determining the group eligible to participate in a top hat plan.

Plan participation must be limited to a select group of management or highly compensated employees. Although it could be argued that the term “select group” relates to the size of the portion of the management or highly compensated employees eligible to participate in the plan when compared to the total number of management and highly compensated employees as a whole, the DOL and the courts have applied the term "select group" as relating to the size of the population eligible to participate in the plan when compared to the employer's workforce as a whole.

The DOL and the courts focus on both qualitative (limiting the group to those in the top tier of compensation and management) and quantitative (limiting the group to a small percentage of the overall workforce). For example, in one court case, a plan that was offered to 15.34% of a bank's employees was held to have been established for a "select group", because all plan participants were selected officers of the bank (assistant V.P.'s, managers, and senior management), in management positions, and were highly compensated in comparison to bank employees at large (i.e., the average compensation of the "top hat group" was more than twice the average compensation of the rest of the workforce).

Very generally, to meet the "select group" requirement, the organization needs to ensure that it has not defined the eligible population too broadly. Often, this is the requirement that generates the advice that the organization include no more than x% of its total workforce in the "top hat group". I have seen this percentage recommendation range from 5% to 20%, and sometimes I find that this percentage limit is the only factor considered for determining the "top hat group". I advise that other factors also be considered.

Although, I have addressed the "select group" factor first, it likely is the last factor to be analyzed, after identifying who is "management" or "highly compensated". In other words, after identifying who is "management" or "highly compensated" for purposes of plan participation, the plan sponsor then will need to confirm that it has not included too high of a percentage of the total workforce as eligible to participate in the plan to be supported as a "select group". So long as the entire group of eligible employees is not too broad when compared to the workforce as a whole (i.e., the entire group is a select group) and each employee in that eligible group is either highly compensated (relative to the employees who are not in the select group) or management within the organization, the group of eligible employees should qualify as a "top hat group".

The term "management" also is subjective. However, the existing guidance has provided some parameters that employers can follow to identify who is "management" for purposes of participating in the top hat plan.

Historically, the DOL has taken a somewhat limited view of the employees who are considered management for purposes of the top hat plan rules. The legislative history of ERISA provides an example of a top hat plan that covers only officers of a corporation. Generally, it is possible that not every single person who manages other employees will qualify as "management" for these purposes. In one of the DOL's withdrawn rulings, the DOL ruled that a plan that covered all employees on the employer's executive payroll was not a plan maintained primarily for a "top hat group" in view of the broad range of salaries and positions held by the participants. As a result, when thinking of "management", the plan sponsor will want to focus on higher ranking management employees within the organization as a whole. Simply being a "supervisor" or "exempt" employee for purposes of the FLSA may not be sufficient.

Naturally, C-suite employees (the chief executive officer, chief financial officer, chief operating officer, etc.) for each organization within the controlled group will qualify for eligibility in the top hat plan. However, once the plan sponsor starts going further down the chain of management, it must ensure that each individual labeled as “management” for purposes of plan participation has actual management responsibilities within the company.

For top hat determination purposes, the Internal Revenue Code's definition of "highly compensated" is not automatically determinative of which employees are considered to be part of a top hat group. The DOL has stated that using a compensation limit, without further analysis of whether each individual is a member of a select group of management or highly compensated employees, is not sufficient for determining eligibility. Rather, the DOL and the courts historically have focused on the average level of pay of those determined to be "highly compensated" for top hat purposes when compared to the average level of pay of those determined not to be "highly compensated". In other words, rather than focusing on a dollar amount alone, the DOL and the courts have focused on the compensation disparity between those who are eligible for plan participation and those who are not. For this reason, when establishing a compensation limit, the plan sponsor first should rank employees in order of their total compensation and then ensure that only those at the top end of the list are labeled as “highly compensated” for top hat plan purposes.

As you can see, after over two decades of guidance from the DOL and the federal courts, there remains very little—or no—uncertainty or confusion regarding the determination of a select group of management or highly compensated employees. What exists is a framework of generalities that allows each separate and distinct organization to make its own determination regarding who is eligible to participate in the top hat plan. This existing flexible framework allows organizations of all sizes and types to take advantage of the very useful recruiting and retention tool of a top hat plan.

(3) Would guidance provide clarity or certainty to these determinations?

Although I do not doubt that guidance might provide clarity or certainty regarding some issues, any guidance would also add complexity, administrative burdens, and additional costs to the

design, implementation and operation of top hat plans. As other witnesses have testified, the issuance of guidance always results in added confusion, followed by the need for additional advice, and unintended consequences of excluding organizations from any meaningful use of plans subject to the new guidance (e.g., small for-profit or tax-exempt organizations that may have the greatest need for the use of a top hat plan).

Any guidance project would need to include considerable allocation of resources to ensure proper coordination with Treasury regulations under Code sections 83, 451, 457(b), 457(f), and 409A, at least. Because we already have over two decades of operation of top hat plans under the current guidance, which seems to be working very well, this allocation of resources for a goal of some added clarity or certainty does not seem to be justified.

The trend in the federal courts is to ignore the DOL position as stated in Advisory Opinion 90-14A, that the top hat group can negotiate their own employment terms and therefore do not need the protections of ERISA. This has made the court decisions inconsistent with the DOL informal positions (and advisory opinion statements). The courts are tending to ignore regulatory guidance, which means any DOL regulatory guidance in this area will not provide certainty because the courts may decide to continue using a completely different set of standards even if the DOL issues guidance.

(4) Does a lack of guidance inhibit the ability of the DOL or affected employees to enforce the law?

"The Employee Retirement Income Security Act of 1974 (ERISA) is a federal law that sets minimum standards for most voluntarily established retirement and health plans in private industry to provide protection for individuals in these plans." (see https://www.dol.gov/general/topic/retirement/erisa). In my experience, the DOL views these protections as primarily applicable to rank-and-file employees and not to the employees who have the means and leverage to negotiate and enforce their compensation and benefit rights.

This DOL view is confirmed in the primary guidance that the DOL has issued with respect to top hat plans, as stated in Advisory Opinion 90-14A, that the top hat group can negotiate their own employment terms and therefore do not need the protections of ERISA.

The DOL and employees (both those designated as eligible for top hat plan participation and those excluded from participation) have very effective tools to enforce the protections of ERISA with respect to a top hat plan. The DOL has a wide variety of audit and enforcement tools for this enforcement. Employees have the courts for this enforcement. These enforcement tools have been in place since ERISA was enacted and have been used effectively in the years since ERISA's enactment. I have seen no evidence that the lack of additional guidance inhibits this enforcement.

The types of enforcement claims available include:

Certain employees to whom top hat plan participation was not offered could successfully contend that, under ERISA's participation and coverage rules, they should have been offered plan participation and therefore should be entitled to benefits under the plan. This type of claim from the rank-and-file employees is unlikely because qualified plan participation is much more favorable to the rank-and-file employees than top hat plan participation (for both tax and risk of forfeiture reasons).

Any Participant (or his or her beneficiary) who was not paid all or a portion of his or her benefits under the top hat plan because the plan contains a vesting requirement that is more stringent than ERISA permits for non-top hat plans, because the plan failed to be funded (i.e., assets failed to be held in an "exclusive benefit trust" beyond the reach of employer creditors rather than in a mere "rabbi trust"), or for other reasons, could successfully contend that he or she should nevertheless receive those relinquished amounts. These types of claims are typical of the claims that have been filed in the federal courts for the past two decades.

In addition to the organization being liable for benefit amounts as described above, certain individuals, committees and/or entities who have discretionary authority or control with respect to the plan could be personally liable as plan fiduciaries if the plan is not a top hat plan and they are found to have breached their fiduciary duties.

The imposition of ERISA's funding requirement (i.e., its requirement that assets be set aside in an "exclusive benefit trust") as a result of not being a "top-hat" plan would mean that each participant would be taxable on his or her plan deferral and contribution amounts as and when earned (or, if later, when vested), notwithstanding that those amounts may not yet be payable under the terms of the plan.

The alternative method of compliance with the reporting and disclosure requirements of Part 1 of Title I of ERISA, described above, would cease to be available, with the result that the plan would be subject to ERISA's full panoply of reporting and disclosure requirements, including its Form 5500 annual reporting requirement and its Summary Plan Description and Summary Annual Report disclosure requirements; and could have potential Code and/or ERISA penalty exposure for failing to have timely satisfied these requirements.

I do not think the lack of additional guidance inhibits enforcement. The DOL already has sufficient authority to monitor, audit, and enforce, and can challenge any top hat determination it believes is inappropriate. In addition, top hat plan participants (and other employees) have access to the courts to challenge any top hat determination.

2. Would enhanced reporting be helpful and appropriate?

Top hat plans now can file the ERISA required filing electronically. The following guidance is on the dol.gov website: "Plan administrators of "top hat" plans must use this web page to electronically file the statement described in section 2520.104-23 of the Department of Labor's regulations. Top hat plans are unfunded or insured pension plans for a select group of

management or highly compensated employees. The Department published a final regulation that makes it mandatory to electronically file the statement. To go directly to the statement, click on the link "Proceed to File Your Top Hat Plan Statement" below."

https://www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/reporting-and-filing/e-file/tophat-plan-filing-instructions

In January 2020, the Employee Benefits Security Administration made available a new online search tool that allows users to search and view Top Hat Plan Statements filed with the Department of Labor (under 29 CFR 2520.104-23) for top hat plans. The EBSA link for this search tool is:

https://www.askebsa.dol.gov/tophatplansearch

Plan sponsors who failed to file the one-time statement with the DOL upon implementation of a top hat plan can take advantage of the DOL's delinquent filer voluntary correction (DFVC) program to retroactively bring the plan into compliance with this requirement.

The existing reporting provides all of the information needed by the DOL to monitor and audit top hat plans. All past and future reporting by top hat plans now is fully accessible on-line by the DOL and the public. Organizations who are unsure about whether they have properly met the filing requirement for a top hat plan can check on-line to determine if they are in compliance, and, if not, they can take advantage of the DFVC program to become compliant.

Enhanced or additional reporting would not be helpful or appropriate. Rather, it would require an allocation of DOL resources to develop and implement the additional reporting, and would impose unnecessary administrative burdens and costs on plan sponsors.

Conclusion.

I agree with the DOL that the individuals who are eligible to participate in a top hat plan have the ability to affect or substantially influence the design and operation of their plan. Often, the plans are completely voluntary or the employer contributions are negotiated in employment contract negotiations. It is my view that guidance is not needed to define a "select group of management or highly compensated employees", and enhanced reporting would not be helpful and appropriate. Therefore, I think there is no reason for the DOL to allocate resources to these issues.