

# 2020 ADVISORY COUNCIL ON EMPLOYEE WELFARE AND PENSION BENEFIT PLANS

## TOP HAT PLAN PARTICIPATION AND REPORTING

### WRITTEN TESTIMONY

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#### Executive Summary

- Specific guidance as to the rules for participation in top hat plans would benefit plan sponsors and their employees by eliminating legal uncertainty and litigation expense
  - The statutory language, legislative history and policy considerations do not support the U.S. Department of Labor’s (the “DOL’s”) historic narrow reading
  - The DOL should provide guidance to the effect that participation in a plan by a small number of employees who should have been excluded from participation in order for the plan to qualify as a top hat plan does not cause the plan to be entirely disqualified from being a top-hat plan
- The current alternative reporting option for top hat plans is both administratively efficient and appropriate
  - Given the limited utility of reporting to the DOL concerning top hat plans, a voluntary correction program is appropriate to permit late filers to comply with the reporting requirements upon payment of a nominal penalty.

#### Statement

My perspectives on the issues discuss herein arise from my 34 years’ experience in private practice at the law firm Cleary Gottlieb Steen & Hamilton LLP advising public and private employers of all sizes on ERISA, executive compensation and benefits matters. For the last few months I have been employed at Citigroup Inc. as General Counsel – ERISA, Compensation and Benefits.

This written statement does not describe the background considerations underlying the issues being considered today, as that background has been described fully in prior testimony and other statements. I address the following two specific questions arising from the U.S. Government Accountability Office’s (GAO) report entitled “Private Pensions: IRS and DOL Should Strengthen Oversight of Executive Retirement Plans”:

1. Should the DOL promulgate bright line objective participation rules for determining whether a plan qualifies as a top hat plan?
2. Should the current alternative reporting option for top hat plans be modified?

#### A. Participation Rules

Any “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” is exempt from the participation, vesting, funding, and fiduciary responsibilities under Title I.

## 1. Underlying Policy

Properly-drafted bright line objective participation rules would be consistent with the policy underlying the top hat plan exception. DOL Advisory Opinion 90-14A includes the statement that “it is the view of the Department 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.”

My experience suggests that the statement in AO 90-14A subtly misses the practical reality of how compensation is set, and compensation plans are designed, in the market today. Specifically, in only a small number of situations does any employee, even the most senior executives, have the practical ability to negotiate or influence the design and operation of his or her employer’s compensation plans. To be sure, many senior executives do have the ability to negotiate the amount of their pay. However, for the large majority of employers, in my experience, the design and operation of compensation plans and programs are not in fact subject to negotiation or substantial influence by individual employees acting for their own interest.

The forgoing observation does not, in my view, undercut the policy purpose of the top hat exclusion; the basic policy underlying the top hat rules very much holds true. That is, there are many employees who by virtue of their circumstances do “not need the substantive rights and protections of Title I.” The ability of those employees to look after their own interests arises not because of their individual negotiating power or influence, but rather arises from a combination of the following factors:

- Their understanding of the financial strengths and risks of their employers, and concomitant ability to make informed decisions about how much pay to electively defer, negotiating the amount of their overall pay package and whether to accept, or continue, employment with a particular employer;
- Their relatively high level of pay, which permits them to assume the inherent credit risk in accepting deferred compensation; and
- The comfort derived from being part of a group of participants that includes the most senior executives of their employers.

The foregoing should counsel in favor of a participation rule for top hat plans that does not disqualify a plan from top hat status merely because a small number of eligible participants do not satisfy a conservative definition of the phrase “select group of management or highly compensated employees”. In particular, it suggests that the word “primarily” should be read to modify that phrase (and not only the words “for the purpose of providing deferred compensation”), so that the top hat disqualification does not arise from any participating employee not being part of the most senior executives of an employer. It also suggests that the relevant inquiry should not be whether each specific participating employee has the ability to influence plan design or operation, but rather whether the group of participants in the aggregate is one which needs the substantive rights and protections of Title I. In that regard, we note that many less senior management employees would welcome the opportunity to participate in the plans designed for senior executives of their employers, and to piggy-back on the generous benefits, rights and features of the plans offered to them by their employers.

In support of this group-based, piggy-back approach to thinking about the participation issue, I note an analogous approach taken under the DOL’s plan asset regulation (§2510-3.101). In those rules, the DOL addresses the circumstances under which a plan’s investment in a collective investment vehicle would make the vehicle subject to the substantive rights and protections of Title I’s fiduciary rules. The

rules provide that if 25% or more of any class of equity in the vehicle is held by benefit plans investors, then the rights and protections must apply to the vehicle. Otherwise, the underlying theory of the rule is that the plans will piggy-back on the sophistication and negotiating influence of the non-plan investors. In my view, a similar approach under the top hat rules would be protective of the rights and expectations of employees who would not satisfy a conservative definition of the phrase “select group of management or highly compensated employees”, and would permit such employees to benefit from plans and programs that are designed and operated for the benefit of an employer’s most senior executives.

## 2. Development of Case Law

The courts have not generated a consistent bright line framework for applying the top hat plan exclusion criteria. Instead, the courts have looked at the relevant facts and circumstances with no single factor being determinative. Also, the courts have generally applied a mix of qualitative and quantitative factors to make a determination. The uncertainties arising from the case law developments have not benefitted either employers or employees, nor have they advanced the policy objectives underlying the top hat exclusion in an optimal way. The following briefly summarizes the principal case law developments in order to illustrate that case law developments over many years have not resulted in a clear and practical guidelines for employers.

### a. Qualitative Factors

Definitions of “highly compensated employee” in Section 414(q) or other Sections of the Internal Revenue Code of 1986 are not designated for use in applying the top hat plan exclusion. The courts and the DOL have usually taken into account the average salary of plan participants compared to the average salary of all employees for top hat plan purposes. In Belka v. Rowe Furniture Corp., (1983) a district court upheld a plan’s status as a top hat plan where the average salary of plan participants was approximately 3 ½ times that of the average of all employees. In Demery v. Extebank Deferred Compensation Plan (B), (2000) the Second Circuit Court of Appeals upheld a plan’s status as a top hat plan where the average salary of participants was “more than double” the average salary of employees. In Callan v. Merrill Lynch & Co., Inc., (2010) a district court also found a 2 to 1 ratio between participants and all employees to be sufficient. Other courts have considered forms of compensation other than base salary. In Fishman v. Zurich American Ins. Co., (2008) a district court took into account all compensation reportable on IRS Form W-2. Similarly, in In re New Century Holdings, Inc., (2008) a bankruptcy court included all compensation, including commissions, earned by an employee in determining whether the employee was “highly compensated.”

The courts and the DOL have looked at the duties, job titles and positions of employees to determine if the eligible participants were “management.” Courts generally do not require employees to fit in a narrow range of the top executives in order to constitute “management,” but have found variants of higher-level managerial employees satisfactory. Many courts have not delved too deeply into this area and several opinions simply state that the plan participants either are or are not members of “management” without further explanation. In Berry v. Wells Fargo & Co. (2017), the named class plaintiff contended that he was not part of a “select group of management” because he had two levels of management above him in his division and he only managed one financial advisor and an assistant.

### b. Quantitative Factors

The courts and the DOL frequently review the number of employees covered by a plan in deciding whether the plan qualifies as a top hat plan. The smaller the portion of an employer’s employees who are eligible under a plan the more likely that the plan will be a top hat plan, but there is no “safe

harbor” percentage threshold of eligible employees where the plan will always be upheld as a top hat plan (assuming the plan also meets the qualitative factors discussed above).

Acceptable percentages have included the following: DOL Adv. Op. 75-64 (Aug. 1, 1975): 4%; Belka v. Rowe Furniture Corp. (1983): 4.6%; Duggan v. Hobbs (1996): 5%; Alexander v. Brigham and Women’s Physicians Inc. (2008): 8.7%; and Demery v. Extebank Deferred Compensation Plan (B), (2000): 15.34%, which the Second Circuit noted that this level was “at or near the upper limit of the acceptable size”. That list suggests that the limit has consistently increased over time. However, the following percentages have been found to be unacceptable: Carrabba v. Randalls Food Markets, Inc. (1999): less than 5%; DOL Adv. Op. 85-37A (Oct. 25, 1985): less than 7%; Daft v. Advest, Inc. (2008): 12.87%; and Darden v. Nationwide Mut. Ins. Co. (1989): 18.7%.

Aside from the numerical limit, the following issues concerning the quantitative test remain open:

- Whether the percentage of employees to be considered are those eligible or those actually participating?
- Whether the percentage of employees covered is based on the plan sponsor’s, or the plan sponsor’s controlled group, headcount?
- Whether the percentage of employees covered should include former employees?

### 3. Plan Bifurcation

The DOL’s amicus curiae brief in Bond v. Marriot International, Inc. (dated May 28, 2015 with the Fourth Circuit Court of Appeals), includes the statement that:

This brief takes no position on the form of equitable relief that would be appropriate, under 29 U.S.C. § 1132(a)(3), to redress an employer's violation of ERISA's vesting requirements in circumstances where the employer erroneously included non-management, non-highly-compensated employees in a pension plan that would otherwise qualify as a top-hat plan under Section 1051(2). In circumstances where (1) the plan included very few such employees, (2) the employer included such employees inadvertently, or (3) the employer had an objectively reasonable basis for believing that such employees qualified as management or highly-compensated for purposes of Section 1051(2), it may be that the appropriate remedy would be to provide relief only to those non-management, non-highly-compensated employees who were improperly included in the plan – e.g., to reform the plan to exclude the non-qualifying employees and award them the full vesting and other protections and benefits while maintaining the plan in its exempt status for the management and highly-compensated employees who do qualify. That approach would avoid providing a windfall gain to the management and highly-compensated employees who could properly have been included in a plan covered by Section 1051(2), who possess sufficient economic bargaining power to protect their own rights and are not the intended beneficiaries of the substantive ERISA provisions at issue.

Bright-line, objective rules for determining participation in top hat plans should mitigate the need of plan bifurcation of the type contemplated by the foregoing statement. However, for the reasons specified by the DOL, a bifurcation approach is in any case reasonable and appropriate, which could and should be provided for in formal guidance, either sub-regulatory guidance or a formal regulation interpreting the top hat language, rather than reserved for future de novo consideration by courts in the course of litigation. The litigation approach would, of course, likely be more expensive than a guidance approach, and could lead to different rules in different circuits.

## B. Reporting Rules

The current limited reporting requirement for top hat plans reflects a determination made in 1975, shortly after the passage of ERISA, that such requirement was appropriate to protect the interests of top hat plan participants. That judgement continues to be sensible in my experience. Specifically:

- I do not recall encountering in my practice any situation that suggested that a deferred compensation plan was established for the benefit of too broad a group of participants in order to take advantage of the lack of sophistication of the participants by providing them with deferred rather than current payment.
- As noted in the preamble to the issuance of the original 1975 reporting regulation, “the application of Part 1 of Title I to unfunded pension plans maintained by employers primarily for the purpose of providing deferred compensation for select groups of management or highly compensated employees would be adverse to the interests of plan participants in the aggregate. Imposition of these requirements might cause employers to eliminate such plans altogether or to curtail benefits offered under such plans.”

If a plan sponsor fails to file the top hat statement with the DOL, the plan could be subject to ERISA’s full reporting and disclosure requirements, and assessed penalties by the DOL and the IRS, including IRS penalties of \$25 per day up to a maximum of \$15,000, and DOL penalties of \$2,233 per day without a maximum limit. Corrections can be made through the Delinquent Filer Voluntary Compliance Program. Given the limited utility of reporting to the DOL concerning top hat plans, continued availability of that voluntary compliance program is appropriate to permit late filers to comply with the reporting requirements upon payment of a nominal penalty.