# Statement of Norman Stein

# Before the ERISA Advisory Council

# Working Group on

# "Examining Top Hat Plan Participation and Reporting"

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Good morning. I am Norman Stein. I am a professor at the Drexel University School of Law, where I teach and write principally in the areas of employee benefits and tax law. I also am Senior Policy Consultant for the Pension Rights Center in Washington. The Pension Rights Center is the country's oldest consumer organization dedicated solely to protecting and promoting the retirement security of American workers, retirees, and their families. I am, however, testifying today on my own behalf and am representing neither Drexel University or the Pension Rights Center.

I appreciate the opportunity to testify on the topic that this work group is studying, top hat plans in the vernacular, or "a plan which is unfunded and is maintained by an employer primarily for the purpose of providing deferred compensation for the purpose of providing deferred compensation for a select group of management or highly compensated employees," in it statutory expression. Top hat plans occupy a privileged spot in the ERISA landscape: they are exempted from ERISA's various substantive consumer protection rules—vesting, funding, spousal protections, fiduciary standards, non-reduction of accrued benefits—but are the beneficiary of ERISA's liability-limiting rules, such as preemption of state law, administrative exhaustion, deferential judicial review of plan benefit denials, and limitations on available remedies.  The two other principal exemptions from ERISA—church plans and governmental plans—are total exemptions, so participants lose ERISA's substantive protections but still have recourse to state law, including state-law remedies.  Thus, participants in top-hat plans, in a real sense, straddle the worst of two worlds, losing ERISA consumer protections but remaining subject to ERISA's preemptive and dispute-resolution limitations.

Although aspects of the tax treatment of non-qualified deferred compensation have received intense policy, academic, and legislative attention, that attention has generally focused on abuse of the constructive receipt doctrine under the tax law, a concern that Congress partly addressed with the enactment of IRC § 409A.  In contrast, the top-hat exemption, which is the primary statutory enabler of non-qualified deferred compensation, has not received as much scrutiny, although the courts and the Department of Labor have tried their hands at charting out the shape and scope of the exemption.  Thus, it is a positive development that the Council is studying this aspect of the top-hat exemption.

The meaning and reach of the exemption is not easily discernable from just the statutory language.  In this testimony, though, I will suggest that Congress intended a narrow scope, exempting only plans that cover key executives (those with meaningful ability to bargain for their compensation package) and certain non-management employees with key-executive levels of compensation (and thus bargaining power akin to that of key executives). I make this claim by examining the statutory language through the tri-partite lens of the statute's structure, the statute's purpose, and the statute's history, which is surprisingly revealing and consistent with respect to the exemption's meaning even though the statutory language itself is somewhat opaque.

Courts have for the most part accorded the top-hat exemption a somewhat more generous scope than the very much more limited scope that I suggest Congress had in mind. Although the cases are a mish-mash of doctrine and are anything but consistent in their conclusions, they virtually all ask two common questions: what percentage of employees participate in the plan (too many mean the plan is not a top-hat plan), and whether the employees in the plan are all, or almost all, management and/or highly compensated employees. In two cases, the Second Circuit has ruled that plans covering, respectively, 33% and 15.34% of the employees, were top-hat plans. (No court has gone further.) While these cases can be explained by their somewhat atypical facts (and thus the holdings may be in cabined by those facts), some commentators have taken these cases as a harbinger of a broadening scope for the top-hat exemption. Moreover, in some top-hat cases, courts generously construe the terms "management and highly compensated employees" to cover low-ranking management employees and employees whose compensation is at best on the outer periphery of any plausible definition of a high level of compensation. Some courts have used the definition of highly compensated in either ERISA's non-discrimination rules or key employees in ERISA's top-heavy rules.

The result is that some plans that hope to fit the top-hat exemption cover employees that are not appropriately embraced by the statutory term "select group of management or highly compensated employees." There is considerable evidence that both the number of top hat plans and the reach of their coverage into mid-level employees has substantially increased over the last two decades. In one recent case, for example, a brokerage firm argued that a plan fit the top-hat exemption even though, by some measures, it covered approximately 20% of the employees, many of whom earned less than the average compensation of the employees as a group.

There are two significant problems with the creeping expansion of the scope of the top-hat exemption. The first problem is the more obvious of the two, and one to which I have already alluded: the top-hat exemption, although intended to apply to plans that cover employees who do not need the substantive protections of ERISA, has been judicially applied to plans that cover employees (often mid-level employees) without such ability. In some of these cases, such employees have forfeited substantial benefits under plan rules that would violate ERISA's central consumer protection, its minimum vesting requirements. (I suspect that the same is true for many plans whose satisfaction of the top-hat conditions has not been litigated.) In other cases, an employer's bankruptcy resulted in middle-management employees forfeiting their retirement benefits at the same time they lost their jobs. Moreover, as I have indicated, participants in top-hat plans are subject to ERISA preemption of state law, various remedial and procedural limitations, and a presumption that plan decisions are correct, limitations they did not face before ERISA's enactment. Thus, participants—with few protections and diminished judicial remedies—are worse off than they would have been had ERISA never been enacted. I do not believe it plausible that this is what Congress intended.

The second set of problems relate to the possible effects of top-hat plans on business enthusiasm for qualified plans. Our nation's retirement policy is, to a significant extent, designed around the tax expenditures we inject into qualified plans, whose non-discrimination rules result in retirement savings for lower and moderate income taxpayers. To the extent non-qualified plans can replicate the tax treatment of qualified plans, employers can be expected to favor them over qualified plans, at least in situations where the employer can design the plan to limit coverage to those employees who most value the tax benefits of deferred compensation and thus not waste coverage on those employees who would prefer cash compensation. Here again the definition of top-hat plan contributes to the problem: a more elastic definition permits a business to design a plan that covers a larger percentage of the employees who value deferred compensation, thus decreasing the incentives for the employer to sponsor a qualified plan (or at least a generous qualified plans) covering more reluctant savers, who will not value the employer's contribution at 100 cents on the dollar. Moreover, at the margins, even a narrow definition of top-hat plans may have a deleterious effect on qualified plans, since top-hat plan participants—who in a narrow definition of the exemption would generally be the firm's top managers—have less of a personal stake in ensuring the adequacy of benefits in a qualified plan, since most of their benefits would come from non-qualified deferred compensation plans.

My testimony will have three section. The first section tries to tease out the meaning and scope of the top-hat exemption, looking at the language and structure of the statute, interpretation by the Department of Labor, and the statute's legislative history. The second section tries to chart how the partial exemption for top-hat plans effects participants in them, both in terms of limiting various ERISA protections but leaving them subject to ERISA limitations on participant rights, particularly in the resolution of disputes. It also describes how the Department circumscribed the ERISA reporting and disclosure requirements that apply to top-hat plans. The third and final section suggests that the Department of Labor should begin a regulatory project to guide plan sponsors and their advisors and the courts and should expand the top-hat plan reporting requirements that that the Department's regulatory actions narrowed. This section, however, also notes some practical and perhaps political constraints on such a project this many years after ERISA's enactment. If the constraints I identify are sufficient to constrain regulatory adjustment, then revisions to harness the scope of the top-hat exemption may rest with Congress.

## I. ERISA and the Meaning of the Top-Hat Plan Exemption.

The top-hat exemption applies to "unfunded plans maintained primarily to provide deferred compensation to a select group of management and other highly compensated employees." These 19 words present one grammatical question and at least six definitional issues. The sentence does not tell us what the exemption means by the words "unfunded," "designed, " "deferred compensation," "select," "management, or "highly compensated." And it is unclear whether the term "primarily" modifies the words "to provide deferred compensation," the words "management and other highly compensated employees," or the words "to provide deferred compensation to management and other highly compensated employees." How these words are interpreted, and which words are modified by "primarily," have obvious relevance to the scope of the top-hat exemption.

To take, for the moment, the grammatical question—what does the word "primarily" modify--the Department of Labor has issued sub-regulatory guidance that the term "primarily" modifies the only the words "designed to provide deferred compensation," but not the words "management and other highly compensated employees." Thus, a plan would not qualify for the top-hat exemption if it covers even a single employee who is neither management not highly compensated. The Department of Labor finds this reading of the statute consistent with its view of the purpose of the top-hat exemption: to cover only those employees who have the ability to affect the terms and operations of their plan, through negotiation or otherwise. An employee who is not a member of a select group of management and highly compensated employees would ordinarily lack this ability.

A majority of the few courts that have considered the issue, however, disagree. The Second Circuit Court of Appeals, for example, has held that the mere presence of a few plan participants who are neither management nor highly compensated does not fatally compromise the top-hat exemption. The opinion appears based on the court's grammatical construction of the exemption, without an underlying policy foundation to support that construction. The Third Circuit has held that a plan that covered essentially all highly compensated employees was sufficient, although it did not cover only a select group of such employees.

My goal in this testimony, however, is not to tease out of the exemption's language a construction of the language that reflects and implements the Congressional understanding of the exemption, at least insofar as it can be derived through the language, structure, and history of the statute. Rather, my more modest goal in this section is to suggest that Congress intended a narrow scope for the exemption, one that covered only senior management and non-management employees with executive-level compensation and that regulatory attention to the many challenging questions raised by the definition is warranted. I will return to a focus on the language of the statute and then consider those pieces of legislative history relevant to the exemption.

A. Language of the Statute

The language of the statute here is itself somewhat instructive, referring to a "select group" of management and highly compensated employees. Read literally, the word select means something less than all of the management and highly compensated employees, presumably selected in other than arbitrary fashion. The exact meaning of the term "select group" is the crux of the interpretive issues presented by the top-hat exemption.

The purpose and structure of the statute, the legislative history of the top-hat exemption, and the Department of Labor's consideration of the meaning of the exemption, suggest that the select group is those key executives and highly paid employees who have sufficient bargaining power and influence to negotiate the terms of their own compensation, including deferred compensation. But there is a definitional question precedent to the meaning of "select group," since the select group is culled from the group of "management" and "highly compensated employees." The statute fails to define either the adjective "management" or "highly compensated," whose precise meaning is not self-evident. Although I will discuss the possible meanings of "management" and "highly compensated," their actual definitions are not necessarily significant if, as I will argue, the select group itself is limited to key executives and employees whose high compensation makes them the functional equivalent, at least in terms of bargaining power and of importance to the business, of key executives.

Beyond the statute's legislative history and structure, there are few reference points to guide us to the meaning of "highly compensated." At the time of ERISA's enactment, the term "highly compensated employee" was not a defined term in either the federal labor laws or the Internal Revenue Code. Congress did add a definition of the term "highly compensated employee" to the Internal Revenue Code in 1986, for use in the various qualified-plan nondiscrimination rules. It is implausible that the 1974 Congress that enacted ERISA intended that the term "highly compensated employee" in the top-hat exemption to have the meaning of a term adopted in 1984 for a different statute with a different purpose. Indeed, the function of the term “highly compensated employee” in the Internal Revenue Code’s non-discrimination rules is to ensure that moderate and lower income employees receive benefits from qualified plans, by requiring a qualified plan to cover a percentage of non-highly compensated employees based on the percentage of highly compensated employees who participate in the plan. If the top-hat and Internal Revenue Code’s definition of highly compensated employee are identical, a business could neatly evade the non-discrimination rules by establishing one or more top hat plans for some or all employees who fit the non-discrimination rules’ definition of highly compensated. This would allow the business either to reduce coverage and/or the generosity of benefits for the employees who do not meet the definition of highly compensated, or to abandon a qualified plan (thus eliminating all benefits for rank-and-file employees). It is improbable that this was what Congress intended and there is certainly no way to read the legislative history to argue the contrary. I will suggest below that the legislative history and structure of the statute contemplates that highly compensated refers to employees whose pay and value are equivalent to select “management” employees.

We can turn to the dictionary and thesaurus for some clues as to what Congress meant by the term “management.” Webster’s most relevant definition of management is “the collective body of those who manage or direct any enterprise or interest: the board of managers” and a manager as “a person whose work or profession is the management of a specified thing (as a business, an institution, or a particular phase or activity within a business or institution).” The New Collegiate Dictionary defines management as “(a) the person or persons managing a business, institution, etc. [and] such persons collectively, regarded as a distinct social group with special interests, characteristic economic views, etc." Black's Law Dictionary defined management as "The people in a company who are responsible for its operation," and the term manager and the term manager as "one who manages a business, institution, etc." The Merriam-Webster Thesaurus offers several synonyms for manager, including executive, but also including supervisor. A lawyer can construct an argument from these jumble of definitions and synonyms for either a broad construction of the term "manager" or a narrow one.

As I earlier suggested, however, we can find strong clues about the scope Congress intended for the exemption from ERISA's structure and purpose and from ERISA's legislative history. Moreover, while the Department of Labor has studiously avoided promulgating regulations on the meaning of the top-hat exemption, the Department has issue some rulings that are consistent with the top-hat exemption having a narrow scope.

What then should we make of the top-hat exemption, given that although ERISA is a remedial statute, the top-hat exemption deprives participants in such plans of ERISA reforms but saddles then with ERISA's various limitations on relief? A non-controversial canon of statutory construction is that exceptions to remedial statutes are narrowly construed. The Senate Committee Report following its markup of the Senate Labor Committee's mark-up, stated that "It is intended that coverage under the Act be construed liberally to provide the maximum degree of protection to working men and women covered by private retirement programs. Conversely, exemptions should be confined to their narrow purpose." Committee on Labor and Public Welfare, Committee Report No. 73-127, 93D Cong. 1st Sess (April 18, 1973) (S.4, Retirement Income Security for Employees Act of 1973). All this suggests that Congress intended a narrow scope to the exemption and that the term "select group of management and highly compensated employees" was intended to limit top hat participants to the subset of management and highly compensated employees that had the ability to protect themselves.

This is essentially the position taken by the Department of Labor in regulatory guidance. In an advisory opinion, the Department has indicated that the rationale underlying the top-hat exemptions is that a select group must be composed exclusively of those employees who "by virtue of their positions or compensation level, have the ability to affect or substantially influence, though negotiations or otherwise, the design and operation of their deferred compensation plan," and thus do not require the substantive protections ERISA accords to employees participating in other types of plans.[1]

The legislative history of the exemption is consistent with the idea of a narrow scope. Of the various House and Senate bills that ultimately morphed into the legislation that President Ford signed into law, the first version of the exemption appears in the S.4., the first of the Senate bills. S.4. was a labor bill, which, among other things, included vesting, funding, and fiduciary provisions. The legislation included seven exemptions from the vesting and funding rules, one of which exempted a plan if "such plan is unfunded and is established or maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management employees and is declared by the employer as not intended to meet the requirements of section 401(a) of the Internal Revenue Code."

That exemption did not, however, apply to the fiduciary provisions of S.4., which were part of an amendment to the Welfare Plan Disclosure Act. That Act provided an

[1] Department of Labor, Office of Pension & Welfare Benefit Programs, Opinion 90-14A.

exemption for plans with fewer than 25 employees, which certainly would have applied to many plans for key management level employees.

S.4.'s introduction was accompanied by a summary of its provisions. The exemption for plan established or maintained for a select group of management employees was described as a deferred certain plans for key executives. The bill was assigned to the Senate Labor Committee and when reported out of committee continued to contain the exemption for unfunded plans established or maintained primarily for the purpose of providing deferred compensation to management employees. As already indicated, the Committee Report noted that "coverage under the Act be construed liberally to provide the maximum degree of protection to working men and women covered by private retirement programs. Conversely, exemptions should be confined to their narrow purpose."

In the Senate, members of the Finance Committee introduced tax pension legislation, which placed new vesting, funding, and fiduciary rules under the jurisdiction of the IRS. The new standards applied to qualified plans and thus did not include exemptions; a non-qualified plan would simply be stripped of the tax advantages of qualified plans. (The Senate Finance bill was intended to compete with S.4. and its provisions provided lighter regulation than S.4.) A subsequent Senate Finance bill would have included tax-favored treatment of plans that did not comply with the vesting and funding rules if the coverage of such plans was restricted to 5% shareholders or corporate officers.

The leadership of the Senate Finance and Labor Committees ultimately crafted compromise legislation. The vesting and funding provisions were housed in the Internal Revenue Code and the fiduciary rules in both IRC and the labor code. The fiduciary rules did not include an exception for plans covering select management employees although the tax provisions continued to permit trusts for plans that were restricted to 5% shareholders.

The initial House labor bill, H.R. 2, like S.4., provided fiduciary, vesting, and funding standards. The bill did not include an exemption for management employees, but did include an exemption from the vesting and funding rules for plans that covered only 10% partners or sole proprietors and from the fiduciary rules for plans that had no more than eight participants. A second House Labor bill included the vesting and funding exemptions, but dropped the fiduciary exemption for plans covering no more than eight participants. The House labor bill, though, when reported to the floor, adopted an exemption for "unfunded plans established *and* maintained primarily for the purpose of providing deferred compensation to a select group of management employees." Recall that the Senate version of this exemption (from which the House borrowed) had provided that the plan had to be established *or* maintained for the exempt purpose, which arguably meant that a plan established for the exempt purpose retained the exemption even if the business later it were not maintained for the exempt purpose. The House version clarified that the plan would lose the exemption if it ceased to be maintained for the exempt purpose. It is probable, of course, that this was just a semantic clarification; it is doubtful that the Senate had intended that a plan would continue to be a top-hat plan if it was no longer maintained for the exempt purpose. The Committee Report accompanying the bill described the exemption as one for "executive deferred compensation plans."

As was the case in the Senate, pension reform proceeded on two tracks in the House, with pension bills emerging from both House Committee on Labor and the House Committee on Ways and Means. The Ways and Means bill, which made vesting a qualification condition, did not include a "top-hat" plan type exemption. The House committees ultimately crafted a joint bill, which amended both the Internal Revenue Code and the labor code with virtually identical vesting and funding requirements. The final legislation that emerged from conference adopted this blueprint as a means of reconciling, or at least deferring until another day, the fierce turf wars between the tax and labor committees over jurisdiction over pension regulation.

The labor side of the House legislation included the exemption for unfunded deferred compensation, but with an important addition: the exemption now applied to "unfunded plans maintained primarily for the purpose of providing deferred compensation to a select group of management *and highly compensated* employees." The inclusion of highly compensated employees expanded the group of employees from which a permissible top-hat group was selected, but in what way? The committee report that accompanied the joint House bill describes the exemption in one place as applicable to "executive deferred compensation plans," using identical language to the earlier House and Senate committee reports, and in another place indicated that the exemption covered "unfunded plans for top executives," new language that first appears in this report. This suggests that the term "highly compensated employee" was added to reflect the reality that some employees, although not executives or management, were comparably paid and had comparable ability to protect themselves without the need for the protections of the statute. It did not result in the drafters of the committee report conceptualizing the exemption as an exemption for unfunded plans covering executives. This was the bill passed by the House, which was considered along with S.1179, by the Conference Committee.

The staff of the Joint Committee on Taxation, examining the bills, contrasted the Senate and House bill exemptions. In reviewing the two bills, the staff compared the language of the management exemption from the labor vesting provisions with the Senate language permitting employers to take deductions for contributions to plans that did not include the forfeiture provisions (and otherwise did not qualify for favorable tax treatment) if the plans covered only officer and 5% shareholders. The two provisions were not, in fact, parallel provisions at all; only the house provision was a true exemption. The Senate bill, on the other hand, imposed no labor-law requirements on unfunded deferred compensation plans and thus plans were free to have forfeiture provisions so long as they did not wish to obtain tax qualification. In any event, the staff suggested that the Senate recede and accept the House exemption, which was included in the bill and which almost immediately after passage of ERISA was referred to as the top-hat exemption.

II. ERISA Provisions Applicable and Non-Applicable to Top-Hat Plans.

There is broad agreement that ERISA is a remedial statute, which was enacted after Congress determined, among other things, "that owing to the lack of employee information and adequate safeguard concerning [employee benefit plans] their operation, it is desirable in the interests of employees and their beneficiaries, that disclosure be made and safeguards provided with respect to the operation, and administration of such plans; . . . that despite the enormous growth in such plans, many employees with long years of employment are losing anticipated retirement benefits owing to the lack of vesting provisions in such plans; that owing to the inadequacy of current minimum standards the soundness and stability of such plans with respect to adequate funds to pay promised benefits may be endangered."[2] To remedy these shortcomings, Congress enacted minimum standards applicable to all retirement

[2] ERISA § 1(a), 29 U.S.C. § 1001(a).

and deferred compensation plans, except those plans exempted from either the statute generally or from a particular set of minimum requirements. I don't believe it is controversial to claim that providing these protections was the overarching goal of Congress in enacting ERISA.

But Congress was also concerned about the costs and burdens to business of the new federal standards and thus also legislated certain liability-limiting concessions for businesses. Thus, participants in employee plans, for example, may not sue for consequential and punitive damages, no matter how egregious a defendant's behavior; may not present their cases to juries; and may not look to state law for substantive protection or judicial relief. As described below, the top-hat exemption essentially denies participants in such plans almost all of ERISA's substantive protections but subjects participants to virtually all of ERISA's limitations on participant rights.

Title I of ERISA, the labor section, includes two subtitles. Subtitle A is entitled General Provisions and include three sections: "Findings and Declarations of Policy[3]," "Definitions,[4]" and ":Coverage.[5]" The coverage provision includes two parts. Part (a) indicates that Title I applies to virtually employee benefit plan except those exempted by Part (b).[6] Part (b) in turn exempts from all provisions of Title I five categories of plans: government plans,[7] church plans,[8] plans maintained solely to comply with workmen's

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3 ERISA § 2.
4 ERISA § 3.
5 ERISA § 4.
6 ERISA § 4(a).
7 ERISA § 4(b)(1).
8 ERISA § 4(b)(2).

compensation laws,[9] plans maintained outside the United States primarily for the benefit of nonresident aliens,[10] and "excess benefit plans."[11]

Subtitle B of Title I includes the Title's regulatory and enforcement provisions. As originally enacted in 1974, Subtitle B included five parts and those are the relevant parts for the top-hat exemption today, since the two parts added by post-ERISA amendments regulate group health rather than deferred compensation plans.[12] Except for Part I, which provides rules for reporting and disclosure, each of the Parts begins with a section defining the Part's coverage. Here, the coverage provisions track those of section 4 of Subtitle I: all employee benefit plans are covered by the particular Part unless either exempt from ERISA or specifically exempted by the Part. Top-hat plans are exempt from Parts II, Parts III, and Parts IV, but are not among the Plans excluded from Part V.

Because the bulk of Title I's consumer protections are derived from Parts II, III, and IV, from which top-hat plans are exempt, and because the procedural limitations on dispute resolution are derived entirely from Part V, to which top-hat plans are subject, participants in top-hat plans lack most of the benefits of ERISA's substantive rules but are subjected to virtually all of its limitations. Thus, participants in top-hat plans occupy an uninviting legal landscape. Before considering the purpose of an exemption that has such consequence, it may be helpful to chart the ERISA protections from which top-hat participants are excluded and

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[9] ERISA § 4(b)(3).

[10] ERISA § 4(b)(4). The term excess benefit plan refers to a type of nonqualified plan that uses the same formula as a related qualified plan, except that the excess benefit plan can provide benefits in excess of the maximum permitted under the Internal Revenue Code. See IRC §S 415(b), (c). Excess benefit plans are discussed in Section 5 of this article.

[11] ERISA § 4(b)(5).

[12] Congress added two additional Parts to Title I in 1986 and 1993, but they create rights with respect to group health care plans and are not relevant to the top-hat plan exemption. See ERISA §§ 601, et. seq. ("COBRA" rights) and §§ 701, et. seq. ("HIPPA" rights).

those few which they enjoy, and the various procedural and remedial limitations that encumber the ability of such participants to obtain relief when they are denied benefits that they would be able to recover in similar cases governed by the law of contract and subject to ordinary procedural rules and legal remedies.

A. ERISA Substantive Protections Denied Participants in Top-Hat Plans

1. Protection Against Forfeiture

Perhaps the most significant of ERISA's consumer protections is the protection that participants in deferred compensation plans enjoy against benefit forfeiture. Prior to ERISA, there were no federal standards protecting employees against forfeiture. Thus, a plan could require a participant to work an unbroken, lengthy period of service to work through a certain designated retirement age with a specified period of service, in order to qualify for a benefit. In addition, a plan could designate forfeiture conditions, such as work for a competitor, that would result in a participant losing a benefit that was otherwise earned. (A few states, such as Wisconsin, began adopting minimum vesting standards in the 1970s.)

When Congress enacted ERISA in 1974, it added minimum standards to the qualification conditions for a tax-advantaged plan. It also included minimum vesting standards in Title I of ERISA. Initially, the minimum vesting standards did not require any vesting until an employee accumulated 10 years of service, but in the period since ERISA's enactment, Congress has reduced the minimum vesting period to 3 years for defined contribution plans and to five years for defined benefit plans. The minimum vesting rules, however, do not protect participants in top-hat plans, because Part 2 of ERISA, which includes the vesting rules, does not apply to such plans.

2. Protections of Benefit from Adverse Amendment

Title I of ERISA provides that an employer generally is prohibited from amending a plan to reduce a benefit that has already been "earned" even if not yet vested. Thus, an employer and employee cannot enter into a contract for deferred compensation that provides the employer with discretion to modify, reduce or eliminate a benefit. This provision, like the vesting provisions (to which it is related), does not apply to top-hat plans.

3. Spendthrift Trust Protections

Title I of ERISA includes a provision that prohibits creditors from reaching benefits in a deferred compensation plan, except in limited circumstances. This prohibition extends not only to third-party creditors, but to the employer itself, which can be an important right, preventing the employer with a claim against the employee from attaching the employee's benefit. This is an especially valuable right, for in addition to protecting the employee's benefit, it bars the employer from a self-help remedy. The spendthrift trust protection, however, is a provision of Part 2 of Title I, so participants in top-hat plans do not enjoy the protection from the employer. In effect, they do enjoy protections against their creditors because the plan is unfunded.

4. Plan Funding

Part 3 of ERISA Title I requires that a plan be funded to ensure benefit payments, and Part 4 requires that a plan's assets be held in a trust, segregated from the employer's assets. Top-hat plans are exempt from both Part 3 and Part 4..

5. Fiduciary Standards

Part 4 of ERISA Title I create an elaborate set of principles and rules that govern the individuals and entities that administer a plan and control and invest its assets. The rules, among other requirements, provide that a plan fiduciary must administer a plan prudently and for the exclusive purpose of providing benefits to participants and their beneficiaries. Top-hat plans, however, are exempted from Part 4 of ERISA and thus participants in top-hat plans do not benefit from ERISA's fiduciary protections.

It might be argued that the fiduciary rules would not, in any event, be fully relevant to top-hat plans because executive deferred compensation plans would not be funded for tax purposes. But funding can mean different things in different contexts. The IRS has long permitted non-qualified deferred compensation plans to be structured so that there is a trust, and so that the trust is funded. The plan will nevertheless be considered unfunded so long as the rights of the participant are subordinated to the rights of the creditors of the corporation in the event of insolvency or bankruptcy. Such plans do have assets and thus a participant would benefit from the protections accorded by fiduciary principles notwithstanding that the plan is considered unfunded for some purposes. In any event, the fiduciary rules govern not only the behavior of individuals who manage the plan's assets, but also those who administer the plan.

6. Spousal Protections

Title I of ERISA also provides some protections for the spouse of a participant in a deferred compensation plan, particularly in terms of survivor rights. Top hat plans do not have to provide spousal survivor protections.

7. Written Plan Documents

Part 4 of Title I requires that a plan be reduced to writing. This requirement does not, however, apply to top-hat plans.

B. ERISA Procedural, Remedial, and Preemptive Limitations on Participant's Ability to Resolve Benefit Disputes.

Part V of ERISA Title I sets out ERISA's enforcement provisions. The provisions are notable for the obstacles that they create for participants to enforce rights against a deferred compensation or its sponsor when the plan denied benefits. Some of these limitations are procedural, some remedial, and some result from ERISA's preemption of state law. Because top-hat plans are not exempt from Part V, participants in top-hat plans are subject to the following Part V limits constraints on participant access to dispute resolution. The limitations are described below.

1. Restrictions on Remedies

ERISA provides jurisdiction for three separate types of participant actions:

(i) section 502(a)(1)(B) provides jurisdiction for participants to bring civil actions for benefits under a plan (and also to enforce plan rights or to clarify future benefit rights);

(ii) section 502(a)(2) provides jurisdiction for a participant to bring a civil action for appropriate relief under section 409, which in turn provides that a breaching fiduciary shall be liable to a plan for any losses suffered by the plan on account of the breach (and for other equitable and remedial relief; and

(iii) section 502(a)(3) provides jurisdiction for a participant to bring a civil action for injunctive or other equitable relief to redress violations of the statute and to enforce terms of the statute and plan.

Clause (ii) is probably inapplicable to top-hat plans, because top-hat plans are exempt from Part IV of Title I, which houses ERISA's fiduciary provisions. This means that participants in top-hat plans are limited to the relief provided in section 502(a)(1)(B) or section 502(a)(3). Section 502(a)(a)(B) has been interpreted to extend only to a cause of action for actual benefits provided under the terms of the plan. A participant cannot under this remedial provision obtain consequential or punitive damages, nor is it likely, given the development of case law, that the participant can enforce oral promises or obtain a remedy if the plan failed to follow a participant's directions.

Thus, a participant who is seeking remedies other than the payment of benefits under the terms of the plan would have to seek relief under section 502(a)(3), which provides that an action may be brought against any individual to redress a violation of the statute or to enforce terms of the plan. Here, though, because top-hat plans are subject to so few statutory protections, the section practically limits actions by top-hat participants, to enforcement of the plan. But the section is likely to be largely useless to a top-hat plan participant because the Supreme Court has held that a participant may only obtain injunctive or traditional equitable relief under this section. Since it is probable that the relief a participant would be seeking the legal damages of monetary relief, section 502(a)(3) would likely have no utility to the top-hat participant. .

2. ERISA Preemption

Participants in ERISA not only are limited by limited federal statutory remedies, they are also subject to ERISA's broad preemption of state law. ERISA § 514(a) (in Title I of ERISA) provides that "Except as provided in subsection (b) of this section, the provisions of this title and title IV shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan described in section 4(a) and not exempt under section 4(b)."

This section has broad preemptive reach, despite a number of exceptions in ERISA § 514(b). Most federal statutes that have explicit preemption sections are structured to preempt state provisions that either conflict with an express statutory provision or, in some cases provide different rules dealing with the same subject. For example, ERISA generally requires that an employee achieve no forfeitable rights to a pension benefit after five years of service for the plan sponsor. Suppose a state statute provided for vesting after only three years. In other preemption schemes, there might be a question whether state law can impose higher standards than the minimum Congress imposed. Here the issue would be whether Congress intended the statute to provide minimum standards that invalidate state laws requiring less, or whether Congress intended to establish a nationwide standard. If Congress intended the latter, then states could not impose tougher standards for citizens of their own states. Some statutes do not include express preemptive provisions, in which case courts have to deduce Congressional intent with respect to preemption. In other cases, Congress spells out with specificity its intent.

ERISA's preemption provision is broader than either of the two models suggested above: it preempts state law that "relates" to an employee benefit plan. Thus, ERISA in some cases will preempt state law relating to an employee benefit plan even though ERISA has no substantive provision addressing the issue. And of course in top-hat plans, where participants have virtually no statutory rights, ERISA preemption means they cannot look to state law to fill in the statutory void. In top-hat plans, preemption can mean, for example, that a participant cannot invoke state-law public-policy limits on forfeitures when a participant goes to work for the employer’s competitor.

3. ERISA Deference to Plan Administrators

The question of what standard of review a court should use in reviewing a plan’s denial of benefits has puzzled judges since the very first ERISA benefits case. There are three plausible standards that might be used under the statute: (i) do novo review, i.e., treating the benefit plan as if it were a contract, with the court using the normal judicial tools for resolving issues that arise under a contract; (ii) contra proferentem, i.e., in which contracts of adhesion—a contract whose terms are determined and written by a single party—are construed against the drafter (in many states, this interpretative approach is applied to insurance contracts); and (iii) discretionary, or arbitrary and capricious, review, i.e., where the plan's determination will not be reversed unless it is arbitrary and capricious.

Legal and policy arguments can be made for each of the three models of review. De novo review is arguably appropriate because a pension plan is a contract and this is the method of review generally used for contracts. It is "fair," since it gives neither the plan, nor the participant, a legal edge when it comes to interpretation of ambiguous language.

Contra proferentem can also be justified. A pension plan is an inordinately complex contract, not easily understood by the layperson; and it is generally drafted by lawyers for the employer, with the employees having no room to bargain. As with insurance contracts, it is arguably appropriate to hold ambiguities against the contract's drafter. Moreover, ERISA provides that pension fiduciaries must administer the plan for the exclusive purpose of providing benefits for participants and deferring reasonable costs of plan administration, which suggests that ambiguities should be resolved in favor of paying benefits.

Finally, deferential review can be justified, since plan fiduciaries are presumably knowledgeable about the workforce, employee expectations, and are more familiar than judges with the language and history of the plan. These observations, however, assume that the plan fiduciaries are independent of the employer, but in fact, are often officers or other employees of the employer, whose interest may well be in conserving assets by not paying benefits in close cases. Most private pension plans fit this latter model and the person reviewing a benefit denial may be operating under the influence of the employer and interpret the plan in favor of the employer's interests.

After ERISA was enacted, most courts looked to Federal judicial experience under the Taft-Hartley laws, which applies to pension plans jointly administered by representatives of the employer and of the labor organization that negotiated for the plan. For Taft-Hartley plans, courts had used a deferential standard of review, reversing plan decisions only if they were arbitrary and capricious. Without examining the differences between Taft-Hartley plans and employer-administered plans, and without considering the differences between the Taft-Hartley law and ERISA, courts uncritically incorporated the Taft-Hartley standard of review into ERISA cases.

In fact, there were major differences between Taft-Hartley and typical ERISA cases. First, and perhaps most important, in Taft-Hartley cases, decisions were made by a board of trustees, who included representatives of both employer and employee, shielding the participant from employer conflicts-of-interest. Second, in Taft-Hartley plans, the benefit formula was typically set, and periodically adjusted, in light of the plan's solvency and the perceived needs of employees and their beneficiaries. Courts often considered these types of trustee decisions and of course there was no legally correct benefit structure—by definition, the plan's benefit structure was subject to human judgment and there is an almost infinitely wide range of reasonable potential benefit structures. Thus, when benefit structures were challenged in Taft-Hartley, courts would not be willing to upset trustee discretion, but would reverse only if the benefit structure could be said to be arbitrary and capricious. In contrast, challenges to employer-administered plans are almost always challenges to an interpretation of benefit eligibility or benefit calculation language. Third, Taft-Hartley did not include explicit provision for judicial review of plan benefit decisions, but did include a provision requiring that plans be administered for the exclusive benefit of employees and their beneficiaries. Courts held that arbitrary and capricious decisions violated this exclusive benefit rule and thus could be "structurally challenged" under the general judicial review structure applicable to Taft-Hartley provisions.

Some commentators, and a few district judges, began to question whether the wholesale importation of Taft-Hartley deferential review was appropriate to the typical ERISA benefit denial case. The Supreme Court ultimately decided the issue in the landmark case of Firestone Tire & Rubber Co. v. Bruch.

The plan before the Supreme Court in Firestone was a salary continuation plan, which provided that in the case of layoffs, employees who lost their positions with Firestone would receive a continuation of their salary under a formula contained in the plan. The plan itself was a mere page in an employee handbook, so lacked the elaborate detail, structure and rules found in a typical retirement plan.

Firestone sold a division and most employees kept their jobs. The employees of the division, no longer employees of Firestone, contended that they were entitled to benefits, arguing in part that the new employer did not have a salary continuation plan. Firestone, noting that its former employees retained their jobs, albeit with a different entity, were not entitled to plan benefits. The district court hearing the case, applying Taft-Hartley-style deferential review, avoided the difficult question of de novo contract interpretation that the case raised, and held for Firestone, noting that Firestone's decision, even if not legally right as a matter of original contract determination, was far from arbitrary and capricious.

The Supreme Court ultimately disagreed. Although an amicus brief submitted by the AARP argued that the appropriate standard under ERISA was contra proferentem, the plaintiff did not argue for this standard, but for de novo review and the Supreme Court decision considered only de novo review and deferential review. Noting the differences between Taft-Hartley and ERISA, and analyzing both contract law and trust law, the Supreme Court held that the default standard of review should be de novo and it remanded the case to the district court to allow it to interpret the plan without giving deference to Firestone's self-serving interpretation. But the court went further: it indicated that the employer and the employee could bargain for a deferential standard of judicial review by including language in the pension plan entrusting plan interpretation to plan administrators. The Court further indicated that if a plan did provide for deferential review and the plan decision-maker operated under a conflict of interest, that conflict would be a "factor" in applying deferential judicial review.

Apparently unknown to the Supreme Court, most pension plans had boilerplate language granting authority to interpret plan language to the plan decision-maker, so the general rule of de novo review would apply to few plans as written. (Recall that the Firestone plan was a single page in an employee handbook and did not include the normal boilerplate provisions that clutter the typical pension plan.) Moreover, following the decision, virtually every plan that did not include the magic language needed to ensure deferential review was amended to include it.

Thus, the "ordinary" rule of de novo review is rarely applicable today and instead, plan benefit decisions made by plan decision-makers whose first loyalty is generally to the plan sponsor, are reversed by courts only if arbitrary and capricious. And courts seldom find that decision-makers are subject to a conflict of interest in pension eligibility decisions, even though their decisions can often affect the size of the plan sponsor's financial obligations to the plan.

The arbitrary and capricious standard has been subject to adverse commentary, focusing on the unfairness to employees, who seldom have an opportunity to "bargain" with their employers about the standard of review that courts will use to evaluate benefit decisions. Of course, in some top-hat plans, which cover senior executives, the language might actually be bargained for. And since the executive presumably was aware of the potential for conflict, it is possible that courts would minimize the importance of any conflict, because the top-hat participant, unlike the typical participant, presumably consented to the conflict.

4. Exhaustion of Administrative Remedies

ERISA has a provision that requires every employee benefit plan to have a claims procedure, the requirements of which are flushed out in regulations promulgated by the Department of Labor. Although the statute does not explicitly require benefit claimants to exhaust administrative remedies before commencing a civil action, courts have required claimants do so, reasoning that Congress would not have included an administrative claims procedure unless it wanted participants to use it.

The requirement that a participant exhaust administrative remedies is often benign. It provides plans an opportunity to correct errors, to respond to new evidence, to engage in communication with the participant in what can be a non-adversarial format, and to consider interpretative issues, again in what can be a non-adversarial format. And it provides participants with a better understanding of their plan, their issues, and the reason the plan has denied benefits or paid less than the participant expects.

But resort to administrative remedies is not always useful. For example, some plans do not regard the process as non-adversarial or an honest opportunity to reconsider decisions. Moreover, in cases involving top-hat plans, disputes often reflect a souring of relationship between the employee and employer and the resort to administrative remedies may be wasteful of both time and effort. Yet courts generally still find the requirement applicable to top-hat plans.[13]

But a participant who fails to exhaust administrative remedies can find his path to the courthouse blocked and thus be denied benefits without reaching adjudication of the merits. The problem is that a court will generally dismiss a case because of a participant's failure to exhaust administrative remedies, unless the plaintiff can prove that exhaustion would have been a futile exercise. And when a judge does dismiss a case, the participant may find that the period for filing an administrative appeal has passed and thus that he can never have her claim resolved by a judge. Moreover, the statute of limitations will often continue to run even if the plan has not imposed time limits on the participant's ability to pursue administrative remedies.

5. Jury Trials

Courts have virtually universally held that a participant in an ERISA plan is not entitled to a jury trial, because ERISA is a statute that reflects equitable principles.

C. ERISA Protections for Top-Hat Participants

a. Protection Against Retaliation

Title I of ERISA makes it unlawful for any person to engage in certain actions, including discharging, fining, suspending, expelling, disciplining, or discriminating against a

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[13] Bechtol v. Marsh & McClennan Companies, Inc., 2008 U.S. Dist. Lexis (W.D.Wa. 2008); Crowell v. Shell Oil Co., 481 F.Supp. 2d 797 (2007).

participant "for exercising any right to which he is entitled under the provisions of an employee benefit plan or [Title I of ERISA], or for the purpose of interfering with the attainment of any right to which such participant may become entitled under the plan or under [Title I of ERISA]. Section 510 also makes it unlawful "for any person to discharge, fine, suspend, expel, or discriminate against any person because he has given information or has testified or is about to testify in any inquiry or proceeding relating to this Act or the Welfare and Pension Disclosure Act." This provision is housed in Part 5 of Title I, which generally includes ERISA's enforcement provisions. Part 5 covers top-hat plans, so participants in top-hat plans receive this protection. The protection, however, are substantially diluted by a participant's inability under ERISA to obtain legal relief.

2. Disclosure

Top-hat plans are subject to Part 1 of Title I, which requires certain disclosures to participants and reporting to the Department of Labor. The Department of Labor, pursuant to a grant of regulatory authority, has issued regulations that excuse administrators of top-hat plans from complying with the requirements of Part 1 so long as the employer files a statement with the Department of Labor that lists the number of top-hat plans maintained by the employer and the number of participants in each plan. Thus, the disclosure reporting and disclosure protections provided to participants in top-hat plans are modest bordering on trivial.

III. Reflections on Moving Forward

I have tried to make clear that courts and employers have extended the Congressionally-intended scope of the exemption for so-called top-hat plans, so that top-hat plans cover mid-level employees who need ERISA's protections. And because the exemption is only partial, it not only removes protections but subjects participants to various ERISA provisions that in fact constrict ERISA rights. Participants in these plans, then, were in a better position before the 1974 enactment of ERISA. This makes it all the more important for the Department to consider regulatory action, which could result in restoring the definition of top-hat plans to its original meaning. Moreover, the Department's top-hat reporting requirements have deprived both the executive and legislative branches of government from access to information about the top-hat exemption, information that would be relevant to possible future regulatory and legislative action. They have also deprived participants of information relative to their benefit security.

I do, however, want to note a practical and perhaps political problem for the Department taking action now. I think it plausible that there are at least many hundreds of thousands of moderately compensated employees who are now participating in these partly ERISA exempt top-hat plans, despite the evidence that such plans may not include participation of such employees. I also believe that it plausible if not likely that most of these plans will, in fact, satisfy employee expectations even though the plan sponsors believe that the plans are not governed by ERISA's consumer-oriented minimum standards. A clarification that a top-hat plan are not permitted to cover such employees could result in these plans terminating or amended to eliminate coverage of these employees, resulting in significant loss of at least future benefit accruals for such employees. Such a clarification might also result in perhaps substantial unexpected liability and compliance costs to for plan sponsors faced with the consequences of having maintained a non-compliant top hat plan. Any Department regulatory project will have to be sensitive to these concerns and sensitivity to those concerns might make a satisfactory conclusion to such a project problematic. Thus, it may be that the Department should initiate an effort to encourage Congress to re-engineer the top hat exemption to better protect those employees who are not in a position to protect themselves through negotiation over the terms of a plan or because of their financial circumstances not well situated to absorb a substantial loss of their retirement benefits in the event of employer insolvency, reduction of accrued benefits, or benefit forfeiture.