Department of Labor
Employee Benefits Security Administration
Advisory Council on Employee Welfare and Pension Benefit Plans

Examining Top Hat Plan Participation and Reporting

Statement of Sheldon H. Smith, Esq.
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Relevant Biographical Information:

I am retired after practicing and teaching ERISA and tax law in Denver, Colorado for forty-three years. I taught qualified and nonqualified deferred compensation (NQDC), welfare benefits and ERISA as both an adjunct and visiting professor of law at the University of Denver Sturm College of Law and in the Graduate Tax Program there from 1980 until my retirement in 2016. My legal practice involved representation of companies large and small, public, and private, as well as governmental and tax-exempt entities. I designed and assisted in the implementation of numerous top hat plans and advised plan sponsors with respect to the legal aspects of providing unfunded plans of nonqualified deferred compensation for the "select group". An abbreviated curriculum vitae is attached.

Perspective of this Statement:

The focus of the Council's request is two-fold, i.e., (1) should there be a regulatory definition/description for the top hat group, and, if so, what should it be, and (2) should the current reporting exception under ERISA for top hat plans be modified. I have been asked to address the Council's request, in part, from the perspective of top hat plan participants and will endeavor to do so in a pragmatic way.

Executive Summary

The rationale for having a top hat test has evolved since 1974. Seemingly, the purpose has been to limit eligibility to those participants who did not need the protection afforded by ERISA when deferring the receipt of compensation. As the courts got more and more involved, the purpose seemed to shift somewhat in order to allow employers the opportunity to include those participants who would assist the employer in meeting its rationale for having a NQDC plan while still limiting participation to those the courts deemed to be management or highly compensated. Courts generally use a definition of the top hat group by focusing principally on the meaning of "highly compensated" and "management".[1] In doing so, the courts utilize a

[1] See, Bruce J. McNeil's statement to the Council provided for the hearing on September 17, 2020 discussing the relevant case law.

facts and circumstances determination. The Department, with its 1990 Advisory Opinion[2], attempted to look at the select group more stringently than the courts often appeared to do.[3] The Advisory Opinion suggests limiting participation to management and highly compensated employees who have bargaining power over the design and operation of the plan. Some courts have disagreed with the rationale for the Advisory Opinion. The use of a bargaining power requirement is practically flawed, but it does demonstrate how facts and circumstances are needed to define the select group. The facts and circumstances determination used by the courts, possibly assisted by a regulatory education/disclosure requirement, best defines the top hat group. The Department's position that top hat plan participation must be limited to management and highly compensated employees who have bargaining power over the design and operation of the plan should be withdrawn and possibly replaced by an education/disclosure requirement as the only change to current law.

Participant Concerns That Might Impact Whether or Not to Impose a Regulatory Definition for the Top Hat Group:

The concerns of participants focus primarily on -

1. Risk of Loss ("unfunded"); and
2. Selection ("select group").

Participant View of Risk of Loss

Because NQDC plan promises are subject to the claims of the employer's general creditors and potential resultant loss of benefits due to the employer's bankruptcy and further due to the fact that all "funded" assets remain property of the employer subject to the claims of the employer's general creditors, the primary concern of participants involves the potential for risk of loss. The concern is most acute with NQDC plans that permit employee compensation deferrals.

Generally, it is when the employer is in financial distress that the participants in the NQDC plan seek to void the plan's ERISA exemption. The case law describes efforts by participants to get a court to determine that the plan fails the select group requirement. See, e.g., *Demery v. Extebank Deferred Compensation Plan (B)*, 216 F. 3d 283 (2d Cir. 2000). Participants have raised some creative arguments to void the ERISA exemption when contending that the top hat requirement is violated and/or that the "funded" assets of the plan are not subject to the claims of the employer's general creditors. See, e.g., *The Lehman Brothers Inc. Deferred Compensation Defense Steering Committee as Attorney in Fact for those Specified, Plaintiffs,*

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[2] DOL Advisory Opinion 90-14A. An advisory opinion is binding only on the party that has obtained it.

[3] The Third Circuit viewed this as an effort to "engraft a bargaining power requirement onto the elements of a top-hat plan." See, Sikora v. UPMC, 876 F.3d 110 (3d Cir. 2017)

against James W. Giddens, as Trustee for the SIPA Liquidation of Lehman Brothers Inc., Defendant, U.S. Bankruptcy Court, S.D.N.Y (June 15, 2020). A successful argument would void the ERISA exemption and cause the plan to be a "disqualified qualified" plan resulting in broad-based participation, vesting and statutory funding, among other requirements. The critical feature is that these NQNC plans are typically "funded" with Rabbi Trust assets, and participants then endeavor to lay claim to them as no longer subject to the claims of the employer's general creditors. In other words, challenging the top hat group status of the plan is a means to an end that involves gaining access to the "funded" assets.

A review of the cases suggests that the courts seem generally to favor the employer's "expanded" size of the top hat group, and the courts prevent access to the plan's "fund" so long as doing so is not unreasonable under the facts and circumstances. In *Demery v. Extebank Deferred Compensation Plan (B)*, 216 F. 3d 283 (2d Cir. 2000), the court approved a plan where more than 15% of the workforce was eligible. The court found the participants to be highly compensated, in management, and "valuable".

There are cases where a participant having lost a NQDC plan benefit through some sort of plan forfeiture mechanism seeks to impose ERISA vesting requirements on the plan by alleging the plan does not meet top hat requirements. See, *Sikora v. UPMC*, 876 F.3d 110 (2017).

It is not realistic, for reasons expressed below, to assume that there can be a workable definition for the select group as facts and circumstances are critical to determining top hat status.

Selection to Participate

In my experience, it was rare to see a plan of NQDC that failed to describe the select group within parameters that met judicially designed requirements.

The court cases and the views expressed by the Department yield five basic *Considerations* for determining the select group:

1. A percentage of the workforce participating in the plan - a ratio test.
2. The compensation amounts of the lowest paid participating employees (by locale) relative to overall compensation - a minimum compensation test.
3. Titles[4], authority, and responsibilities of employees covered under the plan - a management test.
4. The nature of and application of selection (or the pre-adoption design process) to participate provided by the employer.
5. The possibility of a limiting requirement such as the Department's bargaining power requirement – a substantial influence test.

[4] DOL Advisory Opinion 85-37A constrains the use of titles.

The cases might seem inconsistent in applying some or all of these factors to a particular situation, but that is due to application of a facts and circumstances test that endeavors to evaluate whether or not participants are highly compensated or in management.

It is important to consider the *Reasons* that employers adopt plans of NQDC. From my experience, there are three *Reasons*:

1. To reward high-level employees with additional compensation that receives a tax benefit.
2. To attract high-level talent in a competitive environment.
3. To retain high-level talent in a competitive environment.

Highly Compensated Test

The first two *Considerations* address compensation in an effort generally to demonstrate that participants are, as a group, more highly compensated than non-participants. But these tend to beg the basic question: Are these participants, simply by virtue of being highly compensated, in the group that Congress likely felt, and the Department believes, does not need ERISA protection? In other words, when using “highly compensated”, how might one determine if the participant is in the class that does not need to be protected? Does that mean that the highly compensated in a particular employer situation are sophisticated enough simply by being paid in amounts that meet either or both of the first two *Considerations*? Courts endeavor to determine if a highly compensated employee can be a top hat employee using relevant facts and circumstances and the statutory language. The statutory language does not implicate a sophistication requirement.

Management Test

The third *Consideration* addresses management. Management today is different in many companies than it was when ERISA was promulgated. Many companies utilize a Six Sigma-style team approach for management and project work. Non-public, service-based companies may be highly profitable with few employees and no need for old-line structured management, but instead operate as a team. Congress used the disjunctive “or” in its definition of the select group, and, therefore, it is conceivable for an employee to have significant managerial duties but not be paid sufficiently to be included as highly compensated. The desire to find a work-life balance may lead to having part-time, high level managers who are not highly compensated in a traditional sense.

In my experience, designing the select group more often focuses on a top hat group of “highly compensated” employees. By default, in most companies the definition includes those who are in “management”. However, in the modern corporate structure certain managers may not be “highly compensated” according to the plan yet the employer wishes to include them to meet a

Reason. Because of the diverse structures of company management, propounding a specific rule is not realistic nor is it likely to be reflective of true "management". Using requirements like having a position where others report to you may not fit a particular situation. Companies should be allowed to use their own management structure for this determination. Participants would be pleased with this structure as it would allow the *Reasons* to apply to management employees who are not highly compensated but who, based on facts and circumstances, are top hat employees.

Plan Design - Nature of and Application of Selection

In non-public companies, ownership generally decides the design of the plan and the type of attendant "funding", if any. In public companies, the board of directors and/or its compensation committee is primarily responsible for creation of the plan, its design and "funding" methods. The plan's design identifies the class or classes of employees deemed to be in the select group and, therefore, eligible to participate. Plan design in this arena generally falls into three categories: those where the plan is an employer's "funded" unfunded, unsecured promise to pay, e.g., a traditional SERP or an excess benefit plan, those in part or all of which an employee elects to reduce wages in order to "fund" all or part of the deferred promise, e.g., a so-called mirror image salary reduction 401(k) deferred compensation plan, and equity based plans.[5] In plans that include employee deferrals, the design is usually opt-in through salary deferral if the employee is in a "select" class.[6]

The fourth *Consideration* is, with rare exception, a product of plan design. The plan will typically identify the class or classes of those who are eligible to participate. Rarely is there an overt effort to select participants one-by-one except in small plans for a limited group of exceedingly highly paid management personnel who would meet any definition promulgated by courts or the Department.[7] In other words, the select group is created in the plan document by identification of a class or classes that comprise the select group. Selection requirements are imbedded in the plan's design. The first three *Considerations* are subsumed by plan design. Allowing the plan design to continue to define its own select group is sensible in permitting employers to use NQDC plans to implement their *Reasons*. The courts then determine if the plan's classification scheme meets the statutory requirements using a facts and circumstances analysis. This is the most logical approach, and Plan participants do not object to this as a practical matter. In fact, the larger the select group, the greater the ability to challenge its top hat status in litigation endeavoring to obviate the ERISA exclusion.

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[5] The constraints imposed by I.R.C. § 409A have reduced the number of traditional deferred compensation plans, and the employer paid plans are rarely adopted today.

[6] Employers meet the selection requirement by evaluating the nature of the eligible class or classes as part of the plan design process much more frequently than selecting on a participant-by-participant basis.

[7] It may have been only these small plans that Congress intended to be top hat plans. However, that is not the situation today, and any effort to revert to that by imposing a constrained definition of the top hat group would not be well received.

DOL Position

A requirement like the fifth *Consideration* has been and would continue to be difficult to apply, and the courts do not do so uniformly. Its application in the Second, Sixth and Ninth Circuits restricts the select group to the few employees who have bargaining power over plan design and operation. In the First and Third Circuits that bargaining power is not relevant. Adding a factor like the bargaining power factor will be difficult to apply to the current workforce in many companies. For example, potential NQDC plan participants in our service-based economy might be very highly compensated tech wizards who sit at a computer and who have no bargaining power other than to walk down the street and take a job at another company. Due to changing demographics, many of them are much younger than the classes of eligible participants of the past, e.g., those who have moved up the corporate ladder to positions of upper management. Many of these prospective participants may be extremely highly compensated and eligible to participate under a ratio and/or minimum compensation test. And many of them may be sophisticated enough to appreciate the risk of loss and not need ERISA protection. The employer desires to use NQDC to attract and retain them. Yet, they do not possess the bargaining power described in the 1990 Advisory Opinion. They may be critical to the employer's ability to use its plan of NQDC to implement its corporate purposes.

In my experience, it was rare for there to be negotiation over deferred compensation other than the situation where the employer is making a contractual promise to a single individual, typically a prospective candidate for a position such as CEO, CFO or CIO. There were occasions when the compensation committee negotiated with a small group of highly placed employees to create a plan of NQDC. However, there is no concern about that group being a select group, and it is a given that these executives have bargaining power over the design of the plan. From their perspective as participants, none of the *Considerations* would be of concern since they would fall into the select group under any of the numerous definitions. Have we gone too far in expanding the definition of the select group? Should a select group be as much as the 15% of the workforce as in the Extebank case? The court in Extebank found that the participants were in management positions and were highly compensated relative to all bank employees, and it approved the employer's desire to use the plan as a retention tool for "valuable" employees. Other factors were not relevant, and the court used a facts and circumstances approach based on statutory language.

My sense is that the courts have moved the definition of the select group to favor the *Reasons* while relying on the statute. It is unlikely that the Department might create a workable definition that would apply to the diversity of compensation and management structures of American companies. To do so requires a facts and circumstances approach and should be left up to the courts.

Suggestion – An Education/Disclosure Requirement

How might a plan then determine that the employees who meet the plan's definition of top hat also have the requisite sophistication not to need ERISA protection? The Department might require a plan to educate every employee, prior to selecting him or her to participate in a top hat plan. Disclosure would focus on the risk of loss of retirement and tax benefits and how the losses might impact him or her. Each "management" or "highly compensated" employee selected to participate would certify in writing that he or she has been so educated and understands the risk of loss of the employer's promise and the favorable tax consequences. This approach would allow employers to continue to use the three *Reasons* in plan design, would follow the tenor of decisions of Courts of Appeal, and would impose the protection Congress intended to allow for the ERISA exemption. Challenges would yield to facts and circumstances review. This would inure to the benefit of participants generally even though it might dampen their ability to successfully challenge the top hat status of a plan whose sponsor is bankrupt or otherwise in economic distress. The 1990 Advisory Opinion should be clarified to indicate that it was intended to apply to the requestor's plan only, and the Department should adopt an education/disclosure requirement regarding the participant's risk of retirement and tax benefits losses.

Modification to Exemption Reporting

There is no apparent reason to add or change the existing reporting structure for top hat plans apart from the possibility of requiring that they be updated periodically. If an education/disclosure requirement is imposed as suggested, the report should contain a certification that it exists and is applied.

Curriculum Vitae

Sheldon H. Smith
Attorney at Law (Retired-Inactive)

Admissions:

Colorado Supreme Court, Tenth Circuit Court of Appeals, Seventh Circuit Court of Appeals and the United States Tax Court

Education:

Washington University in St. Louis (1970, B.A.)
University of Denver Sturm College of Law (1973, J.D.; 1980, LL.M. in Taxation)

Legal Practice and Teaching:

Law firm practice (1974 – 2016)
Teaching – University of Denver Sturm College of Law Graduate Tax Program (Adjunct Professor 1980 – 1987 and 1989 – 2012) (Visiting Professor 1987- 1989) and University of Denver Sturm College of Law (Adjunct Professor 2012 – 2016)

Continuing Education Instructor, University of Denver Sturm College of Law Graduate Tax Program, Colorado Society of CPAs, 37 other state societies of CPAs and multiple legal and other professional and financial organizations (1982-2016)

ERISA Organizations and Positions:

Fellow, American College of Employee Benefits Counsel
Past President, Western Pension & Benefits Conference
Past President, American Society of Pension Professionals and Actuaries (ASPPA)
Former Director, American Retirement Association

ERISA, Teaching and Legal Community Recognition:

Recipient, Eidsen Award, ASPPA
Recipient, DU Alumni Law Star, University of Denver Sturm College of Law