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Are the "Top-Hat" Plan Participation and Reporting Rules Still a Good Fit?

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Last year began and ended with the release of reports analyzing the current state of the participation and reporting requirements for unfunded, nonqualified deferred compensation plans ("NDCPs") covering a "select group of management or highly-compensated employees" (commonly referred to as "top-hat" plans) and providing the Internal Revenue Service ("IRS") and Department of Labor ("DOL") with recommendations for consideration. In response to a request from three senators, January 2020 saw the U.S. Government

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Accountability Office ("GAO") publish a report on top-hat plans titled "Private Pensions: IRS and DOL Should Strengthen Oversight of Executive Retirement Plans"[1] (the "GAO Report").

Then in December 2020, the Advisory Council on Employee Welfare and Pension Benefit Plans, usually referred to as the ERISA Advisory Council (the "Council"), followed up with its own report[2] (the "Council Report") examining issues arising in connection with top-hat plans.

This column will first review the current state of the top-hat participation and reporting rules to illustrate the concerns and perceived shortfalls that led to the preparation of these two reports. It then will summarize and analyze the top-hat-related findings as well as review the recommendations of each report along with the respective reactions and anticipated, if any, responses that may be taken by the IRS and DOL.

Based on such review, this column will provide NDCP sponsors with a proactive best practice guide for addressing the various potential issues that may arise in this area.

THE STATISTICAL SOURCES AND FINDINGS PRESENTED IN THE GAO REPORT

The GAO conducted a performance audit of top-hat plans from September 2016 to January 2020 in accordance with generally accepted government auditing standards (i.e., standards requiring that the GAO plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for its findings and conclusions based on its audit objectives). Accordingly, the GAO used the following sources:

- Data from Securities and Exchange Commission ("SEC") disclosures applicable to public companies from 2013 to 2017;

- Interviews with a range of industry experts (including attorneys, plan consultants, record keepers, third-party administrators, industry groups, investment advisors, and researchers) that were selected based on a combination of published work, breadth and depth of experience, as well as peer referrals and a random sample of companies that sponsored top-hat plans and filed for bankruptcy in recent years; and

- Interviews with officials from the DOL, Department of the Treasury, the IRS, the SEC, the Pension Benefit Guaranty

Corporation ("PBGC"), and the United States Trustee Program.[3]

THE TOP-HAT TOPOGRAPHY: ENHANCED BENEFITS VERSUS INCREASED RISK/DECREASED PROTECTION

NDCPs serve a valuable function for both key employees and their employers by permitting employers to enter into arrangements under which:

- Such key employees can elect to defer the receipt of their own current compensation and pay taxes on that compensation and earnings upon distribution in a future year; and/or

- The employers may elect to provide such individuals with additional tax-deferred benefits.

Since the chosen "top-hat" employees are typically those individuals whose qualified plan benefits are limited by the various IRS restrictions (such as limitations as to the amount of compensation that can be deferred and/or the cap on the amount of compensation that can be taken into account in determining the amount of benefits that can be deferred or provided), NDQPs greatly increase their potential to make-up for those "lost" benefits and thus accumulate additional amounts in an effort to provide executives with a sufficient income replacement ratio upon their retirement.

From the employer's perspective, these vehicles can be designed to serve a vast array of business needs (e.g., recruitment, retention, incentive).

Generally, there are no statutory limits on the amount of compensation that executives are allowed to defer under a NDCP, the amounts that can be allocated by employers or the benefits the executives can receive through an NDCP.

However, the big trade-off for such executives is that, until these amounts are paid in full, NDCP participants must continue to face financial risks because, subject to certain limited exceptions, all amounts accumulated under the plan are considered an unfunded and unsecured company promise to pay and any assets associated with the plan remain as assets of the company, subject to creditor claims in bankruptcy.

Therefore, unlike qualified plan benefits where benefits are protected from claims of company creditors, the benefits for executives under NDCPs are not guaranteed because executives remain subject to the risk that their company may not pay plan benefits as such benefits are generally unsecured claims (e.g., the executives may not be entitled to their benefits if their company goes bankrupt or reneges on the promise).

Furthermore, the Employee Retirement Income Security Act of 1974, as amended ("ERISA") contains various provisions intended to protect the interests of qualified plan participants and beneficiaries. These protections include requirements related to reporting and disclosure, participation, vesting, and benefit accrual, as well as plan funding. NDCPs that are top-hat plans are exempt from most requirements under Title I of ERISA.[4]

Thus, employees included in these plans do not receive the full protections of ERISA as generally, most of the substantive protections of ERISA such requirements pertaining to participation vesting, funding, and fiduciary responsibility do not apply to top-hat plans.[5] The policy underlying the NDCP exemption from the substantive provisions of ERISA has been described by DOL as based on a recognition by Congress 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."[6]

Additionally, ERISA grants the DOL the authority to prescribe alternative methods of compliance for the reporting and disclosure provisions under Part 1 of Title I of ERISA for any plan or class of plans, which includes NDCPs. Using this authority, DOL issued a regulation permitting administrators of NDCPs to submit a one-time single page filing statement to satisfy ERISA reporting requirements in 1975, according to DOL.[7]

Fortunately, for NDCP sponsors and participants, both the GAO Report and the Council Report (together, the "Reports") acknowledge the importance that NDCPs play in business planning as well as executive retirement planning.[8]

In addition, they both also come to the conclusion, one shared by many if not most NDCP sponsors and practitioners, that the above cited "ability to affect or substantially influence, through negotiation or otherwise" standard is too high a bar to set and thus not a practical restriction to impose at this time given the data that is available regarding the participation levels in these plans.[9]

However, both Reports also raise concerns over:

- The fact that the current limited reporting and disclosure requirements applicable to top-hat plans make it impossible to accurately gauge the current number and nature of the employees covered by these plans;

- The continued confusion over who should be included due to the lack of any specific guidance;
- The possibility of employers expanding participation in such plans so that they go beyond including those select few for whom this exception was intended; and
- The potential negative effects of such "over inclusion" on both the affected participants and other employees of the sponsor.[10]

WHY WORRY OVER TOO LOOSE TOP-HATS?

On an individual employee level, a primary concern with top-hat plans is that the plans extend participation to employees whose position with the company does not fit the top-hat profile and/or does not have the level of financial acumen/security and/or organizational knowledge to be able to sufficiently assess and thereby accept the risk and lack of ERISA protection that comes with such participation.

From an organizational perspective, the Reports raise the issue of the unchecked expansion of NDCP coverage enabling employers to substitute these unprotected benefits for the secured and preferred qualified plan benefits. Below are snapshots of the focus of each Report:

> *The GAO Report*: at the request of U.S. Senators Ron Wyden (D-OR), Patty Murray (D-WA), and Bernie Sanders (I-VT), GAO studied NDCPs and issued its findings in this 71-page report, which focused on (1) the prevalence, key advantages, and revenue effects of top-hat plans; (2) potential outcomes for top-hat plan benefits in corporate bankruptcy; and (3) how federal oversight protects benefits and prevents ineligible participation.

> *The Council Report*: Following up on the issues examined in the GAO Report, the 2020 Council's objective in reviewing top-hat plan participation and reporting was to determine whether guidance is needed to define a "select group of management or highly compensated employees" and whether enhanced reporting would be helpful and appropriate.

The remainder of this column will examine the concerns highlighted above along with methodologies used by each Report that led to the conclusions reached and recommendations proposed before offering a best practice guide for NDCP sponsors in light of these findings.

INSUFFICIENT MATERIALS FOR PROPER SIZING OF THE TOP-HAT GROUP

In addition to the statutory exemptions from substantive ERISA pension plan requirements, DOL regulations also enable NDCP sponsors to obtain complete relief from the reporting and disclosure requirements of Part 1 of Title I of ERISA by utilizing an alternative compliance option. Under this option, an NDCP sponsor will be exempt from filing a Form 5500 annual return/report for the plan, provided they file a one-time statement with the Department within 120 days of establishing the plan and provide plan documents to the Secretary of Labor upon request.

Both Reports came to the conclusion that, given a lack of comprehensive federal agency data on NDCPs, it is difficult to know how costly or beneficial these plans are for executives and companies, and what the revenue effects of these plans are for the federal government.[11]

The problem? The required DOL Reporting on NDCPs does not include complete and timely information on employee participation. While the DOL requires companies to report on their NDCPs, the reporting lacks important information that could allow the agency to identify plans that may be including ineligible employees.

Currently, under its alternative reporting method regulation, the DOL regulations require the administrator of the NDCP, typically the sponsoring company, to submit a one-time single page filing statement within 120 days of the NDCP being established to satisfy ERISA reporting requirements. The sponsor is also excused from all disclosure obligations, including the requirements to supply participants with a summary plan description and summary annual reports.

This filing statement includes:

- The name and address of the employer;
- The employer identification number (“EIN”) assigned by the IRS;
- A declaration that the employer maintains a plan or plans primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees; and

- A statement of the number of such plans and the number of employees in each plan. In addition, plan administrators are required to provide plan documents to DOL upon request.[12]

Since mid-August of 2019, the DOL issued regulations requiring these statements be filed electronically with the thought that such mandatory electronic filing will reduce regulatory burdens on plans and will enable the DOL to make reported data more readily available to participants and the public.

This relatively new web-based filing system also provides an instant confirmation of receipt of the completed filing, a function not available under the prior paper-based filing system. However, these final regulations failed to make any changes to the content of the notices which is a problem according to the findings of both the GAO and Council Reports as they highlighted all the useful information not provided by the statement:

- Job title or salary of executives participating in the plan;

- The percentage of the company's workforce that is eligible to participate, the actual percentage of employees who participate in the plan; or

- A comparison of the salaries of executives with rank-and-file workers.[13]

In addition, because the DOL only requires companies to submit the filing statement once within 120 days of plan formation, it is not aware when participation in the plan changes over time or if plans are terminated. The GAO Report provides an excerpt that reveals that there is some recognition within the DOL that the agency's enforcement abilities would indeed be greatly enhanced with access to additional information:

> When asked if these additional data would be useful to the agency, one DOL official said that they could be used to increase oversight of NDCPs. For example, the official said if the filing statement included the percentage of the company's workforce that participated in such a plan, a high participation percentage could signal to DOL that the company might be permitting employees to participate in the plan who do not meet the "select group" requirements, and that such information could prompt a DOL audit. However, the DOL official said the agency would need to evaluate how the data would be used and the collection costs before determining the data's overall value.[14]

The GAO Report also reveals that it is an accepted fact that the data currently collected can only be used for simple analysis or to facilitate the DOL's ability to respond to requests from Congress, the media, or the public and that this limited usefulness regarding eligibility is due to the age and limits of the original data submitted.

However, despite this recognition, the GAO Report also indicates that, at least for the foreseeable future, the DOL appears resigned to accept these limits because there currently is no plan to place NDCP reporting on DOL's regulatory project agenda.[15] The Report categorizes this as a major obstacle to any effective compliance enforcement initiative in this area because, as it indicates, "Without reviewing or clarifying its reporting requirements to allow the agency to collect more useful information on NDCPs, DOL will continue to lack insight into the composition of these plans and, as a result, may be missing opportunities to ensure that companies with NDCPs are meeting the eligibility requirements for the plan."[16]

Finding the DOL's database to be of limited use, most of the findings and recommendations of the GAO relied on SEC disclosures, court cases, and discussions with industry experts. They acknowledged that using SEC disclosure information is less than ideal for two reasons: (1) disclosures only cover a company's five most highly-paid employees and offer no information on top-hat benefits that may be offered to other employees, and (2) only publicly-traded companies are subject to SEC disclosure requirements, so no information is available for non-publicly-traded companies.[17]

THE PERPETUAL PARTICIPATION PUZZLE

It seems like ever since this "top-hat" exemption was created, NDCP sponsors and practitioners have been primarily left to their devices when it comes to determining how far down the corporate ladder an NDCP sponsor may go when selecting those individuals who can participate without jeopardizing the exemption. While there are some who would feel much more comfortable with knowing the exact specifications that they should follow for their top-hat fit, many others are content with the current loose fit that exists in the absence of any clear-cut, bright-line rules. While the issuance of such exact guidance would eliminate the current uncertainty for the former group, the latter worry that the inherent lack of flexibility of such an approach could inadvertently cause more harm than good for some executives and employers.

Their concern is that the vast array of business needs and organizational structures of all the different employers that sponsors NDCPs make such "one-size fits all" top-hat solution impractical. Such an approach would attain certainty but, as with any bright-line rule, would suffer the detriments of inflexibility. Compensation obviously is sensitive to a number of criteria, including: location (relative cost-of-living); industry (skill, supply, and demand); and a range of business models (small versus large, public versus private, profit versus not-for-profit), etc.

According to the Reports, this problem of the shortfalls in information gathering ability presented by the limited reporting requirements is compounded by the absence of sufficient guidance regarding exactly which employees fit into the top-hat profile.[18] The DOL continues to point to the dated Advisory Opinion 90-14A[19] as its most recent advisory opinion on provisions related to plan participant eligibility. Despite the information in the Advisory Opinion, several industry experts expressed the view that DOL's current policy lacks specific information on the factors companies should consider when establishing eligibility for participation in these plans.

Furthermore, virtually all of the witnesses with respect to these Reports who work with top-hat plans indicated that the notion reflected in Advisory Opinion 90-14A that top-hat status should be limited to employees who have the ability to influence the design or administration of deferred compensation is not useful and is often not taken into account in determining eligibility.

In addition, the Reports reveal via both acknowledgement from the DOL and the following survey results that this combination of effective reporting requirements, clear guidance and thus enforcement capability has left the door open for the denial of ERISA protections to rank and-file employees by allowing them to participate in NDCPs:

> Recent industry surveys . . . have suggested some companies may be extending employee eligibility to a relatively high percentage of their workforce – in some cases, more than 30 percent – and to relatively lower-paid or lower-ranked employees. For example, results from a recent survey of executive retirement plan sponsors suggested that just over 8 percent of respondents offer eligibility to between 20 to 30 percent of their workforce and just over 4 percent offer eligibility to more than 30 percent of their employees. Further, over 20 percent of respondents indicated that over 15 percent of their workforce was considered highly compensated employees and eligible to participate in an executive retirement plan.[20]

The GAO team lacked sufficient data to quantify the extent to which top-hat plans may be permitting participation by ineligible employees but did cite evidence to suggest there was a reason for concern. For example, the GAO Report pointed to certain court cases as contributing to the confusion regarding NDCP eligibility, including cases that have suggested a limit on the percentage of employees who may participate in an NDCP and still constitute a select group.[21]

SUGGESTIONS FOR SOLVING OR ACCEPTING THE PUZZLE

Acknowledging that the issue demands additional study, the Council Report provides the following list of options for consideration:

Do Nothing: This approach is supported by the following arguments:

- The statutory language has been unchanged, and there has been little to no guidance since ERISA was enacted in 1974.

- In the absence of any formal guidelines for making coverage decisions, prevailing practice has been shaped by the various quantitative and qualitative factors that the courts have considered.

- Why disrupt existing practices at this point and that the potential costs of compliance with a new rule would far outweigh any benefit?

- Changes could lead to large scale revisions with significant liability for plan sponsors and unexpected tax consequences for participants.[22]

Bright-Line Definitions: The Council Report indicates that clarity, simplicity, and predictability can be achieved by adopting objective bright-line criteria to define a "select group of management or highly compensated employees" and offers the following examples of how such definition could work:

- Specify a dollar threshold for total annual compensation that would constitute a "highly compensated employee";

- Enumerate a set of executives who would be deemed "management employees";

- Designate the maximum proportion of the company's total workforce or of the group constituting highly compensated employees or management that would be considered a "select group"; or

- Some combination of the above.[23]

Regarding the potential use of a bright-line definition of highly-compensated employee, the Council Report notes that similar quantitative classifications are used for a variety of qualified plan purposes (e.g., prohibitions on discrimination in plan coverage, contributions and benefits, the definition of "key employee" for purposes of the top-heavy plan rules, and the specification of the maximum annual compensation that may be taken into account under a qualified plan).

The Council Report acknowledges that such rules "arguably serve different purposes than the top-hat plan exceptions of ERISA but they demonstrate that numeric definitions are possible and in fact foundational to the retirement plan system. If the qualified plan rules are leveraged, modifications may be needed. It makes little sense for snapshot compensation to drive top-hat plan participation.

For example, an employee who has an unusually large bonus in one year should not be eligible for top hat plan participation that will span many years. One solution would be using look-back compensation over a number of years or considering whether compensation is expected to persist."

Furthermore, the Council Report advises against using the existing Internal Revenue Code ("IRC") Section 414(q) definition of "highly compensated employee" for this purpose because the Council is sensitive to the interplay between nonqualified and qualified plans and is concerned that equating ERISA's top-hat plan usage of "highly compensated employee" with the Code's quantitative definition could undermine the qualified plan system:

> The Code definition of "highly compensated employee" (currently $130,000) is the foundation of the nondiscrimination rules that ensure that rank-and-file employees receive benefits that are comparable to those of highly compensated employees. If the compensation level for top hat participation is defined to mirror the testing definition, the tension inherent in the non-discrimination rules will be eliminated. If an employer's lower-paid workforce puts little value on saving for retirement, the employer could satisfy the demand for retirement savings among its higher-paid employees with a top hat plan. At its most extreme, by creating a work-around for every QP HCE, nothing would need to be put aside for rank-and-file employees who are unable or reluctant savers. Facilitating and incentivizing savings on behalf of those workers (i.e., inducing retirement savings that would not otherwise occur) is a main objective of the nondiscrimination rules. Without that benefit for low to moderate income workers, the policy justification for the enormous tax expenditure afforded qualified plans (estimated to exceed $200 billion annually) would be subverted.

> Put simply, setting top hat plan eligibility at the Code's QP HCE threshold would seriously endanger the qualified plan system for delivering retirement income to middle and lower-income workers.[24]

In contrast, the Council Report's findings were more open to the possibility of defining a "select group of highly compensated employees" by reference to the Code Section 401(a)(17) limit on compensation that can be considered under a qualified plan[25] explaining that this approach would have the following advantages:

- It could effectively protect the qualified plan system by indicating that all retirement benefits for employees earning less than that limit should be provided for through the employer's qualified plan; and

- The 401(a)(17) limit, at more than twice the 414(q) limit, is a better marker for those who may be able to bear the risks, limitations and drawbacks of an unfunded plan that is not subject to the substantive requirements of ERISA.[26]

Select Group: The Council Report also notes that overbroad bright-line definitions of highly-compensated or managerial employees could be remedied by specifying the maximum number of employees, or the maximum percentage of the workforce, that will be considered a "select group."[27]

However, it also points out that this approach may not be ideal because of its insensitivity to workforce composition:

> Firms in different industries employ workers with quite different education, skill level, and experience, so a flat percentage test seems somewhat arbitrary and unrelated to any policy rationale for the top hat exemption. For example, if 20 percent of an investment bank's employees have the financial sophistication to understand, and the financial security to protect themselves from, the risks associated with NQDC, there seems no good reason to bar them from participation just because only five percent of an engineering (or healthcare or computer software) firm's employees possess comparable understanding or security.[28]

Safe and Unsafe Harbors: The Council Report notes that while potentially objective and apparently simple, any bright-line definitions would at best be poor proxies for the policy-relevant considerations (i.e., the need for ERISA's worker protections and the need to maintain incentives for qualified plan sponsorship) and also run the risk of being over-inclusive, under-inclusive, or both.[29]

However, the Report also notes that such bright-line rules could be used not as the "be all and end all" method for determining the acceptable group but could instead be used to delineate clear-cut cases at the ends of the spectrum efficiently. Purely for purposes of illustration, and without taking a position on appropriate line drawing, the Report offers the following example:

- Safe harbor: Total annual compensation exceeding 150 percent of the Section 401(a)(17) limit;

- Unsafe harbor: Total annual compensation less than 150 percent of the Section 414(q) limit;

- Intermediate (discretionary) zone: In this range, a "select group of management . . . employees" would be defined qualitatively by reference to indicia of financial sophistication demonstrating realistic understanding of the risks presented by the absence of vesting, funding, fiduciary standards, protection from accrued benefit reductions, etc., combined with sufficient resources (income or wealth) to bear that risk.[30]

Participant Sophistication Test: The Council Report notes that another possibility is to define eligibility for top-hat plan participation by reference to the ability of management or highly-compensated employees to understand and to bear the risks attendant to these plans by implementing a standard that combines capacity to understand risk, leverage to mitigate the risks, and ability to withstand losses.[31]

Another benefit of this approach is that there are quantitative means of determining participant sophistication in the context of assumption of financial risk. As the Report indicates:

> The Securities Act of 1933 requires the registration of securities that are offered to the public but includes an exception for securities offered to "accredited investors." The SEC has stated that the accredited investor definition is "intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or fend for themselves render the protections of the Securities Act's registration process unnecessary." The SEC definition for accredited investor includes a natural person who "had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse or spousal equivalent in excess of $300,000 in each of those years and

> has a reasonable expectation of reaching the same income level in the current year." . . . There are other pathways for a natural person to be considered an accredited investor including being a "knowledgeable employee" of the employer or having a specified net worth. The policy considerations in promoting retirement security and ensuring that employees receive the compensation they have been promised for work they have performed arguably are stronger than the policies underlying securities laws. Nonetheless, the policy considerations under both regimes somewhat overlap, and the SEC definition of accredited investor is a useful touchstone.[32]

WORST CASE SCENARIOS OF FORCE FITTING TOO MANY EMPLOYEES IN THE TOP-HAT

The Reports describe some of the most problematic outcomes that could adversely those individuals who should not be included in a top-hat plan.

The Lack of ERISA Protection

> Despite not being governed by the most of the substantive provisions of ERISA, top-hat plans are still employee benefit plans and thus when dealing with any claims that arise under such plans, ERISA broadly preempts state law. Accordingly, participants claiming benefits under a top-hat plan would ordinarily be unable to assert causes of action or pursue remedies provided under state law. Furthermore, the Council Report notes that because top-hat plan participants must rely on ERISA's civil enforcement mechanism, ERISA's procedural limitations, including required exhaustion of administrative remedies and review under the deferential abuse-of-discretion standard, apparently apply in tandem with ERISA's remedial limitations. As a result, the Council Report concludes that that top-hat plan participants, who have "few protections and diminished judicial remedies, are worse off than they would have been had ERISA never been enacted."[33]

Negative Interplay with the Qualified Plan System

> The principal concern in these Reports involved questions about "whether top-hat plans are undermining the fundamental policy choice inherent in the qualified plan system: that the availability of generous tax benefits is conditioned on rank-and-file participation on

a comparable basis to highly compensated employees, and that the contributions or benefits provided not discriminate in favor of highly compensated employees."[34] The findings indicated that top-hat plans are not discouraging the formation of qualified plans because top-hat plans are typically offered in conjunction with qualified plans as a supplement to, rather than a complete substitute for, qualified plan savings. However, the Council Report also indicated that:

> [A] number of witnesses suggested that the ability to provide retirement benefits to a broad group of middle management through a nonqualified deferred compensation plan reduces the incentive for employers to provide greater benefits to their rank-and-file workers through qualified plans. . . . [T]op hat plans are often closely coordinated with their companion qualified plans and explicitly designed to provide benefits that cannot be provided under the companion plan due to various limits imposed by the qualified retirement plan rules. These limits include the actual deferral percentage/actual contribution percentage (ADP/ACP) tests (the special nondiscrimination tests for 401(k) plans), the limit on elective deferrals, the limit on annual compensation that may be taken into account under a qualified plan, and the limits on contributions and benefits. he very design of these plans takes pressure off the nondiscrimination rules applicable to qualified plans. It is entirely plausible that, without the ability to broadly offer top hat plan benefits, employers would choose to provide more robust benefits under qualified plans. In the absence of hard data, it is possible that top hat plans are materially undermining the qualified plan system. We view this issue as the central public policy question underlying this topic.[35]

THE THREAT OF BANKRUPTCY

The GAO Report noted that the bankruptcy and industry experts that were interviewed in connection with the GAO Report provided the following feedback:

- NDCP participants as general unsecured creditors may expect to sustain a significant or even a total loss of their deferred compensation in a company bankruptcy.

- The level of losses or recoveries depends on the facts and circumstances of each case, including the type of bankruptcy the company filed.

- Paying plan benefit claims in a bankruptcy often depends on the financial health of the company and the value of the executive to the future of the company.

- Not all NDCP participants receive the same treatment for their claims.

- A common scenario is to preserve in some manner the benefits for key executives who are retained, while giving executives who are not retained, or former executives no longer with the company, less favorable treatment as a general unsecured creditor.

- Some NDCP participants' benefits may be preserved or the participants may be provided with more favorable treatment because they are key executives who need to be retained to help ensure their company successfully reorganizes and emerges from bankruptcy.[36]

In addition, the GAO review of bankruptcy cases showed differences in expected benefit losses and recoveries based on whether the bankrupt company intended to continue to operate by filing a reorganization plan or sell all of its assets to pay creditors by filing a liquidation plan.[37]

THE CONCLUSIONS AND RECOMMENDATIONS OF THE GAO REPORT

The GAO Report has three recommendations for the DOL:

(1) The Secretary of Labor should review and determine whether its reporting requirements for NDCPs should be modified to provide additional information DOL could use to oversee whether these plans are meeting eligibility requirements.

(2) The Secretary of Labor should explore actions the agency could take to help companies prevent the inclusion of rank-and-file employees in NDCPs and determine which, if any, actions should be implemented.

(3) The Secretary of Labor should provide specific instructions for companies to follow to correct eligibility errors that occur when rank-and-file employees are found to be participating

in NDCPs, and should coordinate with other federal agencies on these instructions, as appropriate.[38]

AGENCY REPLIES TO THE RECOMMENDATIONS FROM THE GAO REPORT

DOL stated that it does not have plans to issue guidance or regulations regarding NDCPs, citing, among other considerations, existing resource constraints and priority regulatory and guidance projects in development, and that it would not be advisable to shift resources from other projects.

The GAO Report continues to maintain that DOL's one-time single page alternative reporting for NDCPs lacks important information sufficient to help the agency identify whether companies may be including ineligible employees in its plan and DOL's current data on NDCPs has limited usefulness due to the age and limits of the original data submitted. DOL also stated that the agency has not encountered evidence of systematic abuses involving NDCPs or that ERISA's claims procedure rules and judicial remedies are inadequate to protect participants' benefit rights.[39]

THE CONCLUSIONS AND RECOMMENDATIONS OF THE COUNCIL REPORT

Following up on the issues examined in the GAO Report, the 2020 Council's objective in reviewing top-hat plan participation and reporting was to determine whether guidance is needed to define a "select group of management or highly compensated employees" and whether enhanced reporting would be helpful and appropriate.

Based on the testimony and research received and for the reasons stated below, the Council came up with the following recommendations to submit to the DOL:

1. Require that top hat plan sponsors notify eligible participants of the risks associated with the absence of ERISA's substantive protections, including the risk of nonpayment in the event of insolvency and, if applicable, any risks of forfeiture or repudiation.

2. Revise the alternative reporting regime for top hat plans to:

    a. Require reporting every three years or, if earlier, upon ceasing to cover any employees;

b. Include, at a minimum, the following data elements (treating all plans as a single plan):

   i. Number of employees of the employer;

   ii. Number of employees eligible to participate in the plan;

   iii. Number of employees eligible to participate in the plan who are earning less than the amount in effect under Section 401(a)(17) of the Internal Revenue Code of 1986, as amended (the "Code");

   iv. Number of employees who are eligible to elect to defer compensation to the plan;

   v. Number of eligible employees who accrued deferred compensation in the plan under a formula used for determining benefits in a qualified plan of the employer but applied without regard to one or more limits applicable to qualified plans under the Code;

   vi. Number of eligible employees whose benefits are "funded" through a rabbi trust; and

   vii. The present value of deferred compensation owed under the plan, determined using any consistently applied method, provided that this reporting requirement should not apply if the present value is less than $5 million or fewer than five employees are eligible for the plan.

3. Issue a Request for Information (an "RFI") seeking comments from interested stakeholders on possible regulatory definitions of a "select group of management or highly compensated 9 ERISA Advisory Council December 2020 employees," including possible bright-line definitions and/or safe harbor/unsafe harbor definitions. The RFI should specifically request comments on: a. whether anchoring top hat plan eligibility to an employee's "ability to affect or substantially influence, through negotiation or otherwise, the design and operation of the deferred compensation plan," as suggested by Advisory Opinion 90-14A, is useful, and b. whether expansive definitional criteria undermine the level of benefits and contributions provided under tax-qualified retirement plans.

4. Consult with the Treasury Department on whether current access to top hat pension plans undermines coverage or benefits provided under qualified plans.[40]

BEST PRACTICE GUIDE FOR NDCP SPONSORS

Based on the information conveyed in the Reports, including details of the respective reactions of the DOL and IRS, it appears that that the DOL and IRS currently have neither the priority nor the resources to address the various issues raised regarding the current state of the top-hat eligibility and reporting requirements.

Nevertheless, due to the recent attention devoted to this topic and the fact that executive compensation in general continues to remain a prime target for the press and politicians, there is no guarantee that the status quo will survive indefinitely.

Accordingly, NDCP sponsors should continue to be very selective in inviting employees to participate in these plans and consult with their employee benefit consultants and legal advisors in order to determine how much leeway their organizations' particular set of facts and circumstances provides them in terms of setting the participation limits for their NDCPs.

In addition to taking extreme care with their participation selection process, NDCP sponsors should provide NDCP participants with as much information regarding not only the benefits but also all the risk (e.g., lack of ERISA protections, possible loss of some or all of benefits in the event of sponsor's insolvency) associated with the participation in an NDCP.

While, unlike qualified plan sponsors, NDCP are not required to provide a Summary Plan Description to participants, creating and distributing a similar communication piece to participants is a proactive means of preventing future claims that participants did *not* fully understand what they were getting into (and the associated risks to their benefits) when they joined the NDCP. Another recommended practice would be to include a similar caveat summarizing such risks along with a statement that the participant understands the risks directly above the signature line on any applicable election forms the participant must sign prior to entry.

On the reporting requirement front, all NDCP sponsors should be aware that the DOL now offers an on-line search tool[41] that enables sponsors to find whether or not their top-hat statements are timely filed with the Department of Labor (i.e., this statement must be filed with the DOL within 120 days of the plan's inception). Sponsors can search by entering as much information as they have in at least one of any of the following fields: "Employer Name," EIN, or "Plan Name."

The following excerpt provides additional instructions for users:

> For example, if you are looking for any Top Hat Statements that contain "partner" in the employer's name, type "partner" in the Employer Name field. The search is not case sensitive. If you wish to broaden your search, use the "*" at the end of your search term. For example, if you enter partner* the search results will include filings that contain variations of partner, such as partners and partnership, as shown below.
>
> To narrow your results, enter as much information as you have in the remaining fields. To print your search results, click on the printer icon above the search results on the right side of the screen. You also may download the search results to Excel by clicking on "Export to Excel." If you wish to view or print a filing, click on PDF in the last column of the search results. To print the PDF, use the print function in Adobe. If you are unable to find a filing that you believe has been submitted, please contact Public Disclosure at telephone 202-693-8673 (not a toll-free number).[42]

Prior to the institution of the mandatory electronic filing requirement followed by the creation of this electronic database and search engine, NDCP sponsors had to file the statements by certified mail (return receipt requested) in order to obtain and retain written evidence of the timely filing of their top-hat statement. The potential consequences of not filing the statement can be quite severe (i.e., if the alternative method of reporting and disclosure is not satisfied by filing the one-time statement, the plan is technically required to have had filed an annual report on Form 5500 for the applicable years and failure to timely file Form 5500 can result in IRS penalties of $25 per day up to a maximum of $15,000, and Department of Labor penalties of $2,194 per day without a maximum limit).

Fortunately, any such failure to file can easily be corrected by completing a submission under the department's Delinquent Filer Voluntary Compliance Program ("DFVCP"),[43] provided that such submission is made prior to (1) the date on which the administrator is notified in writing by the DOL of a failure to file a timely annual report under Title I of ERISA, and/or (2) receipt of a DOL Notice of Intent to Assess a Penalty. However, an IRS late-filer letter will not disqualify a plan from participating in the DFVCP.

The applicable submission/penalty fee is capped at $750 for each DFVCP submission, without regard to the number of plans maintained by the same plan sponsor for which the notices and statements are being filed or the number of participants covered by the plan or plans.

Accordingly, given the relative affordability and administrative ease of this filing, NDCP sponsors who have any doubt regarding the status of their top-hat statement filing would be prudent to utilize the DOL search engine and, if needed, make a DFVCP submission as soon as possible.

In addition, NDCP sponsors should note that while, as the Reports detail to their chagrin, NDCP sponsors are not required to file a new or amended statement when amendments are made to or participation levels change in the NDCP(s) for which they have already filed a statement, there are some circumstances that do require an additional filing.[44] For example, an existing top-hat filing by an employer does not cover a new top-hat plan that is subsequently adopted.

Whether a new arrangement is a separate plan or rather is part of an existing plan is determined under all of the facts and circumstances. In addition, a new filing is required in cases where the plan sponsorship if the NDCP changes from one entity to another.

CONCLUSION

The release of these two Reports demonstrates that while the much debated question of exactly what/who constitutes a "select group of management or highly compensated employees" is definitely still on the regulatory radar of both politicians and other government officials, until further guidance is issued, such question remains very much open to interpretation. Although there certainly are advocates for establishing some sort of clearer guidelines for determining top-hat eligibility (e.g., if not via a true bright line test, then at least through the creation of some sort of general safe versus unsafe harbor rules), the majority of NDCP sponsors and practitioners appear to favor a continuation of the uncertainty versus potentially losing flexibility that could result from being saddled with a strict eligibility limit.

The good news is that each Report indicates that there seems to be virtually universal agreement that the "ability to influence employment terms" standard that was long ago floated by the DOL, but never gained traction, is not a valid criteria that can or should be enforced. Both Reports brought attention to the fact that the limited nature of the top-hat reporting requirements currently in effect do not provide the DOL with the information necessary to accurately assess the number of NDCPs out there as well as the make-up of the participants.

Both Reports also addressed the issue of whether there are any corrective options to remove "non-top-hat" individuals from NDCPs especially in light of the problems that could create with respect to IRC 409A compliance. However, the reaction from the IRS and DOL to the Reports indicate that neither agency currently has the interest, leadership nor the resources needed to embrace the Reports' recommendations as a call to action – whether via rule changes or audits.

Nevertheless, the Reports do raise many valid points that should be considered by NDCP sponsors even if the recommendations for increased reporting and agency enforcement never materialize.

Key among these considerations are the continued need for careful selection of NDCP participants and adequate disclosure to NDCP participants to ensure they have sufficient levels of financial information and understanding to know that the trade-off for donning the top-hat is having to be without many of the protective layers that ERISA would otherwise provide. These considerations are important because, even if the DOL never specially defines "select group of management or highly compensated employees," requires additional enhanced reporting to assess what employers are actually doing on this front and/or enhances enforcement via an active audit program, NDCP sponsors still face the risk of a disgruntled participant who suffers damages due to the lack of ERISA protection seeking restitution in court.

Accordingly, in order for to insulate themselves as much as possible from such lawsuits, NDCP sponsors must continue to work with their employee benefit and legal counsel to monitor the participation levels in their NDCPs to ensure that they are comfortable that they have a defensible position in case such levels are challenged. In addition, given the attention the Reports shone on what they characterized as the current woefully insufficient top-hat reporting requirements combined with other recent developments in this area (e.g., mandatory electronic filing of the compliance statement and the DOL's creation of the search engine for such statements), NDCP sponsors should check to make sure that all of their NDCP plans have complied with filing requirements in a timely fashion and can be located on the DOL's database.

Any NDCP sponsors who do not have documentation of these filings and/or cannot find their plan(s) on the database, should consult their employee benefit and legal advisors and consider the DOL's Delinquent Filer Program which offers a simple and relatively inexpensive alternative for compliance.

NOTES

1. Private Pensions: IRS and DOL Should Strengthen Oversight of Executive Retirement Plans, GAO-20-70 (Jan. 2020).

2. 2020 Advisory Council on Employee Welfare and Pension Benefit Plans. Examining Top Hat Plan Participation and Reporting (Dec. 2020) (the "Council Report").

3. GAO-20-70, at 2-3.

4. NDCPs that qualify as "excess benefit plans" are wholly exempt from ERISA. *See* ERISA §§ 3(36). However, "excess benefit plans" are limited to NDCPs that permit contributions or benefits beyond the limits of Section 415 of the IRS Code. *Id*. Accordingly, most NDCPs do not qualify as "excess benefit plans" and must satisfy the top-hat plan requirements to be exempt from most ERISA provisions.

5. GAO-20-70, at 5-6.

6. *See* GAO-20-70, at 5-6; Advisory Opinion 90-14A.

7. GAO-20-70, at 6-7.

8. GAO-20-70, at 6, 23; Council Report, at 4.

9. GAO-20-70, at 6.

10. *See* GAO-20-70, at 46-55; Council Report, at 57-58.

11. GAO -20-70, at 56-57; Council Report, at 57-58.

12. GAO-20-70, at 6-7; Council Report, at 15.

13. GAO-20-70, at 47-48; Council Report, at 53-54.

14. GAO-20-70, at 48.

15. *Id*., at 49.

16. *Id*., at 49-50.

17. Council Report, at 24.

18. GAO 20-70, at 50-51.

19. The Advisory Opinion restates that NDCPs are excluded from most of ERISA's substantive protections and describes DOL's view that the term "primarily," as used in the statute, refers to the purpose of the plan – the benefits provided – rather than the participant composition of the plan. The Advisory Opinion further states DOL's view that NDCPs that include employees who are not from a select group of management or highly compensated would fail to constitute a "select group" under ERISA, which would subject the plan to all of the requirements of Title I. *See,* Advisory Opinion 90-14A.

20. GAO-20-70, at 52.

21. For example, in one case identified by industry experts, the U.S. Court of Appeals for the Second Circuit suggested that an executive retirement plan that allowed 15.34 percent of its workforce to participate was "probably at or near the upper limit of the acceptable size for a 'select group.'" *See Demery v. Extebank Deferred Comp. Plan (B)*, 216 F.3d 283, 289 (2d Cir. 2000). An earlier case identified by industry experts from the U.S. District Court for the Eastern District of North Carolina found an executive retirement plan that covered an average of 18.7 percent of employees during a certain period to be "too large to be considered 'select.'" *See Darden v. Nationwide Mut. Ins. Co*., 717 F. Supp. 388, 396-97 (E.D.N.C. 1989).

22. Council Report, at 39-41.

23. *Id*., at 41.

24. *Id*., at 43-44.

25. The limit, which is periodically adjusted for changes in the cost-of-living, is $290,000 for the 2021 plan year.

26. Council Report, at 44-45.

27. *Id.*, at 46-47.

28. *Id.*, at 47.

29. *Id.*, at 48-49.

30. *Id.*, at 49.

31. *Id.*, at 40-51.

32. *Id.*, at 51.

33. *Id.*, at 16.

34. *Id.*, at 34.

35. *Id.*, at 35.

36. GAO 20-70, at 32-40.

37. *See*, GAO 20-70, at 32-40, Council Report, at 35.

38. GAO 20-70, at 57-58.

39. *Id.*, at 52.

40. Council Report, at 9-10.

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

42. *https://www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/reporting-and-filing/e-file/top-hat-plan-search-instructions*.

43. *https://www.dol.gov/sites/dolgov/files/ebsa/about-ebsa/our-activities/resource-center/faqs/dfvcp.pdf*.

44. GAO-20-70, at 46.