Employee Benefits and Executive Compensation: Getting Ready for 2024 – Top-Hat Plans
Speakers: Jim Earle and Joshua Gelfand
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Jim Earle:

Hey, everyone. You're tuned in to the final edition of Troutman Pepper's *Employee Benefits and Executive Compensation* Podcast Miniseries, Your Compass for Navigating the Complex World of Benefits and Compensation as we close out '23 and head into '24. Today, we're going to focus on so-called top hat plans. What are they? Why should you care about them? And what do you need to do to have them comply with ERISA?

I'm Jim Earle. I'm an executive comp partner in the Employee Benefits and Exec Comp practice in our Charlotte, North Carolina office. I focus mainly on public company executive compensation matters. And I'm joined today by my partner, Josh Gelfand. Josh, do you want to tell us briefly about your practice?

Joshua Gelfand:

Sure. Thanks a lot, Jim. I'm Josh Gelfand. I'm an Executive Compensation Partner in the Employee Benefits and Executive Compensation practice in our New York office, focusing primarily on private equity, private company M&A, transactions as well as carry interest work.

Jim Earle:

Cool. Thanks, Josh.

So as mentioned, we're talking about "top hat plans." This is a concept that relates to certain plans covered by the Employee Retirement Income Security Act of 1974, what we call ERISA. But before we get into that, let's start a little higher. Josh, what is ERISA? What type of plans are covered by ERISA?

Joshua Gelfand:

So ERISA is, as you said, the Employee Retirement Income Security Act. It's a federal law that was enacted in 1974 that sets minimum standards for most voluntarily established retirement and health plans in private industry to provide protection for individuals in these plans. So what does that mean? The idea essentially is, the government wanted to provide protection for individual employees that were relying on pension plans and other type of retirements and benefit plans to ensure that they are properly funded, that they're not burdened in terms of what the vesting and forfeiture risks are, and things of that nature to allow and ensure that employees are getting the protection for their retirement that they are trying to achieve, or that they're told they will achieve.

That's the framework that we're starting out with when we talk about ERISA and when plans could be subject to ERISA. That's what the government is really focused on in the law.

Jim Earle:

Gotcha. So I guess, there's also probably plans that aren't covered by ERISA. I know we're both compensation lawyers. What are some of the things we might be dealing with that aren't ERISA plans?

Joshua Gelfand:

That's a very good question. I think a lot of what we deal with and a lot of what we look at in the executive compensation area is outside of the ambit of ERISA. ERISA really has two types of plans that it covers, welfare plans and pension plans. So, a welfare plan is one that primarily the goal of which is to provide welfare benefits. So, medical, dental, vision, the kinds of things you typically think of as your suite of welfare and healthcare benefits. Oftentimes... Most of the time, in fact, compensation plans like bonus, severance, supplemental retirement plans, those are obviously not going to fall under, or typically would not fall under welfare plans.

Where it becomes a little bit more murky, I think, is around the second category covered by ERISA, which is retirement plans. Retirement plans or pension benefit plans. You might think of the typical one as, I work for 10 years, 20 years, I get a pension and annuity and use that over time. Or, I have a 401(k) plan that I put money into. Those are covered or typically would be covered by ERISA. I think that where it becomes a little bit more murky is around compensatory plans that might have a component that ties into ERISA. So typically, bonus and compensation plans are not pension plans unless they provide retirement income to employees or they result in a deferral of income by employees for periods extending to the termination of covered employment or beyond. So if you're going to pay something out in the long future, it might fall into this requirement as an ERISA plan.

Jim Earle:

I've got clients that have long-term incentive comp plans and they give awards, and it might be a restricted stock unit award that vested over three, or four, or five years. Also, maybe can vest when you terminate employment or if you retire, it might continue to vest. Is that an ERISA plan?

Joshua Gelfand:

Typically, not. Oftentimes, when you think about it, it really has to do with one that is pushed out to retirement or to separation from service or some later period. The view is that might be one of the payment events. But if it's not the primary focus, if you've got an arrangement, like you were suggesting, that vest pays on a fixed date, a separation of service or a change in control, let's say, that's not going to necessarily be viewed as covered by this. The purpose of it is not to push it out to just separation or retirement.

Jim Earle:

It hasn't "systematically deferred" the compensation determination or beyond.

Joshua Gelfand:

That's right. I think that's the key. Because there's a carve out under the rules for bonus plans and for things like we were just discussing. And the key being when the regulators look at it, like the DOL, they say, "Well, does it systematically defer the payments until termination of employment or beyond or provide for retirement income?" So if it doesn't do those things, generally you'll be okay.

But there are times, and I think what we're going to talk about now, where you might push into that. Because you might have situations where incentive compensation could look like that. If you've got, and we'll get into this a little bit more, if you've got a deferred comp plan that says the only payment date is 15 years out from today, well now it's starting to look more like a plan that would be covered by ERISA or could be covered by ERISA.

And so I think the next point, though, is that there is an exception. There's a plan called a top hat plan, which can give you extra protection. I think, Jim, maybe you want to spend a couple of minutes explaining what a top hat plan is?

Jim Earle:

Yeah, absolutely. In addition to, I would say, incentive plans that may have a real long-term to them and are considered systematically deferred, sometimes we set up plans intentionally that are "pension plans" under ERISA that aren't intended to be qualified retirement plans, 401(k) makeup plans, supplemental executive retirement plans or SERPs that are clearly pension benefits. So that plus some of these longer-term comp arrangements that might actually be a pension plan, those are subject to ERISA.

But we don't want them to be subject to all the parts of ERISA, because ERISA includes certain things like funding requirements, minimum vesting requirements, minimum participation requirements, fiduciary duties regarding investment of plan assets, that don't work for these types of plans we're talking about. Non-qualified deferred compensation plans can't be funded. They actually have to be unfunded to work from a tax perspective.

So ERISA has a category of plans that we call top hat plans, and to me it echoes Monopoly. That dude's name, by the way, his name is Rich Uncle Penny Bags, the guy with the monocle. And what does he have? He has a top hat. So the top hat plan evokes Rich Uncle Penny Bags. A top hat plan under ERISA is a pension plan, but it's one primarily for, this is the key phrase, a select group of management or highly compensated employees. If you have something that is a top hat plan and meets that definition, it gets out of those bad parts of ERISA, like funding, minimum vesting, minimum participation, fiduciary duties, which you have to have in order to be able to offer that kind of plan.

Although it's not, and we'll talk about this some more, it's not out of all of ERISA's requirements. Some ERISA is good for employers. ERISA when it was adopted wasn't just about making things more protective for employees. There was a balancing act. It also made things workable for employers, including a requirement that claims be decided through a claims procedure that the courts will give deference to if properly followed by requiring that the rules are going to be preempted from state laws, so you're not subject to the whims of each state's own particular laws, but you have a federal law that governs the plans, and there are no punitive damages

under ERISA. So there's some things that are good from an ERISA perspective as an employer. And top hat plans do generally get to enjoy those.

Joshua Gelfand:

I think sometimes there's a misconception that top hat plans are exempt from ERISA, but it's not that they're exempt, it's that they're just these limited obligations and requirements, some of which, like you said, benefit the employer.

Jim Earle:

Yeah, Josh, actually, if you go read ERISA, you'll never see the words, top hat. And you won't see one little section.

Joshua Gelfand:

Rich Uncle Money Bags in ERISA? I don't know if that's-

Jim Earle:

Yeah, he's not listed in there. But if you search for the phrase, 'primarily for a select group of management or highly compensated employee,' you'll see it pop up a couple times as an exception to certain sections.

Joshua Gelfand:

When you think about it conceptually, it makes sense, because the whole idea is that ERISA was designed to protect employees and protect their retirement accounts. And the view is, well, you don't need as much protection for the people at the top of the chain who have more negotiating leverage and power and the ability to control their fates, and they're more sophisticated, arguably.

Jim Earle:

That's right. That's totally right, and that's definitely an underlying philosophy. We'll see how that plays out in a little bit in some of the decision-making process about whether you've actually got a good top hat plan or not.

Joshua Gelfand:

Let me ask you a question. You said that a plan to be a top hat plan has to be primarily for a select group of management and highly compensated employees. What does that mean? Is there guidance on that? Is there discussion?

Jim Earle:

Right. Because the key. It comes down to a lot of times how you define who's eligible for the plan. That's probably the place where things can go off the rails sometimes. If you're trying to set up a new non-qualified deferred compensation plan or some pension makeup plan, you got

to really think through what group you're going to be able to extend that to. Or if you have one of these long-term incentive comp plans that only pays out following retirement, who are you making eligible for that? That is the key question.

And there is no bright line test on what a select group of management or highly compensated employees are. There are actually even grammatical questions sometimes asked in court cases around select group, is that modified management only? Does it modified management and highly compensated employees? Is it a plan that's primarily for those folks? What does that primarily mean?

Joshua Gelfand:

The DOL takes a pretty, no pun intended, a labored reading of it when it says 'primarily'. No, no, no. Primarily doesn't modify select group of management and highly compensated employees. It's only allowed to cover them. Primarily modifies the later provision that the benefit arrangement is primarily for this purpose.

Jim Earle:

Yeah, exactly.

Joshua Gelfand:

So people in general, even though the words might on the page sound like, well, you can cover them plus maybe some subgroup of other employees-

Jim Earle:

That's right.

Joshua Gelfand:

... Most practitioners take the perspective that no, it's got to be only for select group of management and highly compensated employees.

Jim Earle:

That's right. That's the way I'd normally talk with clients about it. You might have a key executive assistant, but they're not really select group of management or highly compensated employee. I don't think you want to let them in. Highly compensated employee, that echoes and sounds like IRS concepts. 401(k) plans, you got to test for non-discrimination for highly compensated employees, and the code has a definition for that. Not the same meaning here.

So this really is something that has developed through court case and court decisions and DOL opinions. And what you'll see in the court cases when they consider this issue is looking at the facts and circumstances taking into account a mix of both quantitative and qualitative factors. You can read different cases and there'll be different focuses and different emphases on those, but one thing that's really common to see is as a quantitative factor, what percentage of the workforce are you covering?

There's one case where about 15% of the workforce was covered by the plan and it was found to be a legitimate top hat plan. Another case where 20% of the workforce was covered and was not found to be a legitimate top hat plan. So the orthodox advice on the percentage of the workforce covered, again, this is just one factor, it shouldn't exceed 15%. We don't have a case backing that up. Lesser is better. I think less than 10% is probably green light, 10 to 15%, is yellow light. Let's look at the rest of the factors. So that's a factor.

Joshua Gelfand:

That's a lot of what I've seen as well in terms of the threshold. There's a rule of thumb what they consider what's safe.

Jim Earle:

That's right. But the other one that's quantitative, I think, Josh, is pay level. And there have been some court cases, again, nothing that lays down a strict rule. But if you look at the average compensation of the group that's eligible for the plan and you compare that to the average compensation of the entire workforce. And I had someone ask me this question. Is that the average compensation of everybody who's not eligible or the average compensation of the entire workforce? The cases that have looked at this, looked at the average compensation of the entire workforce. You look at that against the average compensation of the eligible group, if that eligible group's average compensation is basically two times or more that average compensation of the whole workforce, that's a favorable factor.

Joshua Gelfand:

And I think what you were saying about looking toward the overall workforce, looking at the percentage, that's helpful too. I had a client; we were setting up a plan trying to give some thought to whether or not it was a top hat plan or not. And the first flush like, well, we're going to cover 58 people. We might even go up to 75 depending on as more and more go. And if you look at this subgroup of the team, that's a large number of people, but the overall size of the company was in the tens of thousands of employees. When we zoom out to that site and say, well, looking at that factor, you're well below the percentages. So we were able to get comfortable. There's a very strong argument that this is a select group.

Jim Earle:

Yep. And I think as a practical matter, what I often see public company clients do when they're considering a plan is they look at their internal hierarchy. They got bans or classes, salary bans, et cetera, and they'll start eligibility at some threshold hierarchy level, which first of all, a big part of that group is probably "management". And we're probably talking about a select group of "management". Or they're at least highly compensated employees looking at this other factor. But a lot of times you want some eligibility determination guideline that as a business you can follow, so you're not making judgements on individual basis.

Joshua Gelfand:

Yeah, agreed.

Jim Earle:

But Josh, you had mentioned earlier the underlying philosophy of why top hat plans don't have all the protections of ERISA for employees. That factor about the individual, are they in fact able to negotiate their own terms of employment? The DOL, you'd said it, they're more labor friendly. They've said that they think that ought to be a factor too in deciding whether you have a top hat group.

I think the courts have largely rejected that. It's pretty impractical. If you have a big public company, a hundred thousand employees and you want to let 5,000 of them in a 401(k) makeup plan, not all 5,000 of those employees are Rich Uncle Penny Bags. Some of them are just somewhere in the hierarchy, but they can't really negotiate the terms of their employment.

Joshua Gelfand:

Yeah. No, I agree with that. And actually that reminds me one other thing I wanted to just highlight. When you're talking about negotiated arrangements, different types of arrangements, in some sense, there's also the risk that people might not always be aware or think of that there are some negotiated plans that you might not think of as being an ERISA pension plan or a top hat plan, but that might fall into that.

Going back to what we were saying originally, ERISA would cover plans that provide for a systematic deferral of compensation to retirement or separation from service. You might have some form of a plan of a deferred comp arrangement that you might think is just a bonus plan, but if it pays out, let's say, far out or only on separation, it might still be covered. And there's a bit of ambiguity. I don't think there's a bright line. But in terms of common rule of thumb, at least one that I've seen, I'd be curious to hear your thoughts as well, is if you're pushing it out less than 10 years, you're probably pretty safe that it's not considered a retirement plan. If you're pushing it out more than 10 years, it's pretty risky. And then 10 years is going to be the cut.

So if you have a plan, and I've seen clients when this occurred where they would say, "This is a deferred comp plan. Vested over time or vest it today, and it's going to pay out 12 years from now." At first blush, you might not be aware, but practitioners have to be cognizant of the risk there and that it might be important to view it and treat it like a top hat plan and avoid the risk of failing to qualify it. And to make it qualify as long as you're with a slight group, it's really just putting in claims procedures and making a very simple, straightforward filing. So there's not a lot of downside for doing it, and it could be protection on the risks.

Jim Earle:

That's a good point. And sometimes a plan like that, you might hear a client say, "We have a broad philosophy on compensating and we want all our salaried employees in this." This is when that ERISA top hat issue might come up. Another place that can come up, and we'll talk a little bit about what does it take to comply that catch people by surprise, are executive severance agreements. Severance, which is obviously payable only after termination of employment, it raises the specter of pension. Severance is a type of welfare benefit. So, severance plans usually fall in that welfare plan category. But the ERISA regulations have a "safe harbor". But what it says is that if the severance is paid over a period of more than two years and more than two times your pay, it goes from being a severance welfare benefit to a

systematic deferral of compensation to termination of employment or beyond, potentially. So you have to be careful, and this could come up with a CEO agreement that has a three x severance paid over three years. You have to pause and say, "Is that a top hat plan? Do we need to think about some of the compliance issues associated with it?" Or marking things when a client asks due in due diligence, "Do you have any top hat plans?" You might need to put it in that category.

Joshua Gelfand:

That makes sense.

Jim Earle:

So Josh, we got something and we didn't set it up right. What are the risks? What happens if we didn't limit eligibility correctly?

Joshua Gelfand:

Well, it's interesting. I think that the biggest risk is that you're covered under a risk, so you're in a risk of benefit plan and you have not qualified as a top hat plan, and therefore you'd be subject to all of the additional other requirements of ERISA, the funding requirements, vesting requirements, disclosure, everything. And the biggest problem is going to be by its nature with the types of arrangements that we would think of as polling as a top hat plan, they're not going to be funded. They might have different vesting. And so you run the risk of breaching all of those other requirements of ERISA and having the exposure to litigations and other claims. Then you failed to fund the plans. You should have done this. That the vesting was not what was required under ERISA. And so you expose yourself on those areas.

Jim Earle:

Yeah, gotcha. So if you've got a top hat plan, just comply. And you mentioned, it's pretty easy to do. You said something about a filing. What is that?

Joshua Gelfand:

The good thing is it's a pretty simple process. Another thing I should say also between talking about it is you're subject to the disclosure requirements of ERISA. So usually if you're under ERISA, you've got to put out an annual filing called the 45500. You have to give all the information on the plan. All these other hoops you have to jump through that you would've by definition failed to have done if you don't qualify as a top hat plan, or if you don't submit it.

To qualify as a top hat plan is pretty simple though. As we said, you've got the requirement that you have to be for a select group of management and highly compensated employees. Beyond that, you have to have a claims procedure in your documents. That's again, not so difficult. And you make this filing, and the filing is very straightforward. If you go online, they're publicly available. And you can see it's got maybe three, four things in it. It's one page long oftentimes, and that's it. All it really tells you is it's the name of the company. You give the plan name. You have to give the number of employees that participate. And also, I believe, the other plans you might sponsor that are top hat plans. And it's very straightforward and there's not a lot of

information that you need to disclose. There's not really a lot of risk or concern that the company would have in making this type of a filing or disclosure.

Jim Earle:

Right. Nowadays, there's a website link at the DOL, the employee benefits, the EBSA, whatever that subgroup of DOL is, and you do it once and you never have to worry about it, even if you later amend the plan.

Joshua Gelfand:

That's right. And I think the good thing also is in terms of exposure, let's say you messed up, you didn't put the filing together, but you otherwise qualify. There is a corrections policy in place, and essentially one of the keys that you just simply need to do is make the filing. So if you do discover that there's an issue, but nobody has pursued it, there's no claim, you should posthaste, make the filing before there's a problem because you can correct it, I think, as long as you've not been audited on this point before you detect the failure.

Jim Earle:

Right. I think the technical way it all works is when you first establish a plan, you got 120 days to do this online, one-page, simple one-time filing, no fee. It turns out you didn't do that, or this comes up, I know you and I've had this in probably due diligence in transactions, and you spotted deferred comp plan. By the way, there are ways to search whether there was a top hat filing made in the past. There's an online link you can go to that you could put in the EIN number and the company name and see whether they have any top hat filings.

But if they've never made a top hat filing and you want to clean it up, you're right. All you do is you do the top hat filing, then you make a filing with the DOL under this thing called the Voluntary Late Filer Program. It's a real simple filing that you make with the DOL. And you pay a $750 fee for filing, but that's nothing. That's easy to do, and then you're fixed. I guess if you don't, you run a risk. If you've got a top hat plan that has never filed and you end up in litigation over it, whoever you're fighting with can use leverage against you and say, "We're going to go to the DOL because you never did a top hat filing." And because you never filed a 5500, the DOL can assert late 5500 filing penalties on you. And those can be massive. So this is low risk, simple stuff to take away a risk of a potentially high claim.

Joshua Gelfand:

I think the takeaway there is if you learn or there's a concern that you have a top hat plan and you haven't put the filing in corrected as soon as you can, because the cost is not that high and the benefits are great.

Jim Earle:

Exactly. Awesome. Josh, I think that's probably a good place for us to stop then. So, hope you all have found this discussion to have been useful. If you got any questions or need further clarification on any of these topics discussed, please don't hesitate to reach out to Josh, me, or anybody else in the Troutman Pepper Employee Benefits and Executive Compensation group.

This session wraps up our ongoing Employee Benefits and Executive Compensation miniseries we've been doing about what you need to think about for 2024. Josh and I enjoyed this so much. I think we may have some more podcasts we'll set out there on some other practical issues related to comp plans, especially 4098 compliance. I'm sure that'll be something everybody will want to hear. And don't forget, we have an annual webinar scheduled in September 2024 for our Employee Benefits and Executive Compensation practice. That's going to cover what you need to worry about for year-end 2024.

Thanks for listening. Josh, thanks. Enjoyed it.

Joshua Gelfand:

Thanks so much. Me too.

Jim Earle:

Take care, guys.

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