WRMarketplace

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TOPIC: Recent Settlement Highlights Risks Associated with Top Hat Plans

MARKET TREND: A recent $79 million settlement in the case of *Berry v. Wells Fargo* serves as a reminder of the unsettled nature surrounding the definition of "top hat" plans under ERISA.

SYNOPSIS: In *Berry*, Mr. Berry (the named plaintiff) and a class of former and current financial advisors filed a lawsuit against Wells Fargo and certain other defendants alleging that the financial advisors did not receive money owed to them under the "Wells Fargo Advisors, LLC Performance Award Contribution & Deferral Plan" (the "Plan") due to an allegedly illegal forfeiture provision. Berry argued that the Plan was a "pension plan" under ERISA but did not qualify as a top hat plan, and as a result Wells Fargo breached ERISA by failing to satisfy certain minimum vesting and funding requirements under ERISA. Wells Fargo, on the other hand, contended that the Plan did in fact qualify as a top hat plan and therefore was exempt from those ERISA requirements. Notwithstanding the parties' arguments, Wells Fargo and Berry ultimately settled the lawsuit for $79 million, including $20 million in attorneys' fees.

TAKEAWAYS: Employers with nonqualified deferred compensation plans ("NQDC plans") should carefully review their plans to determine if the employees eligible to participate in the plan are limited to a top hat group of employees. But because ERISA does not provide a bright-line test for defining the top hat group, employers may still face risk of employee claims, especially if the NQDC plan includes forfeiture provisions.

Background on "Top Hat" Plans

ERISA imposes a number of requirements on "pension plans," including plans that provide for retirement income or that provide for deferral of income to termination of employment or beyond. Most NQDC plans are "pension plans" under ERISA.

ERISA requirements for pension plans include minimum participation, vesting, and funding requirements. ERISA provides an exception from these requirements, however, for plans established primarily for a "select group of management or highly compensated employees" – more commonly known as "top hat" plans.[1] Indeed, for NQDC plans to successfully defer compensation, they need to be a top hat plan that is exempt from these ERISA requirements, especially ERISA's funding requirements.[2]

ERISA does not provide a bright-line test for determining whether a pension plan qualifies as a top hat plan. Courts generally apply a mix of quantitative and qualitative factors to make the determination as to whether a covered group of employees qualifies as a "select group of management or highly compensated employees."

- Quantitative measures: generally focused on the percentage of an employer's workforce that is eligible to participate.
- Qualitative measures: generally focused on the positions, duties, and compensation of those eligible to participate.

The details on the factors differ by circuit, but the Sixth Circuit lists the following as relevant factors in determining whether a plan qualifies as a top hat plan that can be a helpful starting point:

> "(1) the percentage of the total workforce invited to join the plan (quantitative),

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1 29 U.S.C. § 1051(a)(2). Note that top hat plans may also refer to certain executive welfare benefit plans, but this article will focus on NQDC plans.

2 Although top hat plans are exempt from many of ERISA's requirements that otherwise apply to pension plans, top hat plans are subject to certain ERISA requirements, including claims procedures and ERISA preemption of state law. These aspects of ERISA can be helpful for employers. Courts may treat benefit claims decided by employers under ERISA claims procedures with greater deference, and preemption means that certain state law claims (which may come with potential punitive damages) should not apply. Additionally, top hat plans are subject to limited reporting and disclosure requirements, which can be satisfied through a simple, one-time filing with the DOL, thereby avoiding annual 5500 filings and summary plan description requirements.

(2) the nature of their employment duties (qualitative),

(3) the compensation disparity between top hat plan members and non-members (qualitative), and

(4) the actual language of the plan agreement (qualitative)."[3]

To qualify as a top hat plan, a NQDC plan should limit participation to either "management" or "highly compensated employees":

- Management: generally includes managers, officers, executives, and other similar titles.

- Highly compensated employees: Where plan participants earn on average more than double the average of all employees, courts have generally considered them "highly compensated." Note that this definition differs from the IRS definition of "highly compensated employee" used for qualified retirement plan nondiscrimination testing rules.

Some courts and the DOL have also required that the group of employees covered by the plan have a sufficient level of bargaining power over the terms and conditions of their employment, but this qualitative "bargaining power" factor has been rejected by other courts.

A NQDC plan that fails to qualify as a top hat plan potentially subjects the employer to significant tax penalties, DOL penalties, and employee lawsuits. For this reason, when setting up a NQDC plan, it is very important to make sure that it qualifies as a top hat plan.[4]

The Plan at Issue in *Berry*

Beginning in 1994, Berry worked as a financial advisor for Wells Fargo (and various predecessor employers) until 2014 when he retired. While Berry was employed by Wells Fargo he participated in the Plan for about 10 to 12 years.

The Plan provided eligible financial advisors, including Berry, with an opportunity to earn certain "Performance Awards" and "Special Awards" credited to each participant's account under the Plan. Each award required the participant to remain employed for a designated term before the award would vest, usually within 5 to 7 years after the award was made. The participant's account was adjusted for deemed investment earnings based on deemed investment choices selected by the Plan's administrator. Accounts were generally payable after vesting, but

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[3] *Bakri v. Venture Mfg. Co.*, 473 F.3d 677, 678 (6th Cir. 2007).

[4] For more information on top hat plan qualifications, please see our prior Marketplace article "Top Hat" Plans — What are They and How Do You Know If You Have One.

the participant could make a deferral election at least 12 months in advance of the vesting date to push the payment out by at least five years.

A participant's account would generally forfeit if the participant terminated employment before the scheduled vesting date. But if the participant qualified for "retirement" (generally based on meeting a minimum age and service requirement stated in the plan), the participant could continue to vest and be paid the participant's account per the original schedule. The participant, however, had to meet several additional conditions to qualify for retirement vesting treatment, including refraining from competing for a period up to three years, transitioning existing clients, and signing a release of claims. Breach of any of these conditions would result in forfeiture.

Because the Plan permitted participants to defer payment of vested account balances, it needed to qualify as a top hat plan for purposes of ERISA. The Plan, in fact, expressly stated that participation was intended to be limited to "a select group of management and other highly compensated individuals."

Berry's Argument that Plan Benefits Were Impermissibly Forfeited

When Berry retired from Wells Fargo in 2014, he met the age and service requirements to qualify for retirement vesting treatment under the Plan. But within one month after retiring, he founded the Berry Financial Group. Because he formed his own financial services business, Wells Fargo enforced the forfeiture clause in the Plan. As a result, Berry forfeited about $200,000 under the Plan.

In 2017, Berry filed a complaint in the United States District Court District of South Carolina on behalf of all participants in the Plan. The Court later certified a class of defendants that generally included all participants who had their Plan balances forfeited since 2011 – a group of about 2,500 individuals.

Berry argued in his complaint that the Plan was a pension plan subject to ERISA but that the Plan did not qualify as a top hat plan. Berry made several arguments as to why the Plan failed to qualify as a top hat plan.

- Berry alleged that the Plan failed to meet the "primary purpose" factor for a top hat plan. The "primary purpose" provides that the plan is "maintained . . . primarily for the purpose of providing deferred compensation." Berry reasoned that the primary purpose of Plan was not to provide for the deferral of compensation because it contained a forfeiture clause. Berry argued that the actual purpose of the Plan was to function essentially as "golden handcuffs" in order "to restrain trade by imposing on departing employees an unenforceable penalty."

- Berry further contended that the Plan was not a top hat plan because the plan was not limited to “a select group of management or highly compensated employees.” Berry argued that in practice, the Plan covered thousands of on-the-ground financial advisors who were not part of a “select group” of management or highly compensated employees. Berry stated that he was not part of a “select group of management” because he had at least two levels of management above him in his division and he only managed one financial advisor and an assistant.

- Berry also argued that the Plan was not a top hat plan because the participants had no ability to affect or substantially influence the design and operation of the Plan on an individual basis. According to the complaint, the Plan was provided to Berry and the other class members on a take-it-or-leave-it basis.

Berry contended that the Plan, as a non-top hat pension plan, failed to comply with ERISA in several respects. First, ERISA generally requires benefits under a defined contribution plan that are subject to “cliff vesting” to become 100% vested once the participant has three years of service with the employer. Berry argued that the vesting conditions in the Plan, including a 5- to-7-year service requirement following each award and post-retirement forfeiture conditions, violated this ERISA requirement. Berry claimed that neither he, nor the other class members, would have forfeited their Plan accounts had ERISA’s minimum vesting rules been applied.

Berry also argued that the Plan failed to comply with ERISA’s funding requirements because Wells Fargo failed to create, fund, and maintain trust funds for the Plan participants’ benefits.

Berry further asserted claims based on his allegations that Wells Fargo never filed annual Form 5500 reports or delivered summary plan descriptions to participants, under ERISA’s reporting and disclosure rules that generally apply to pension plans. (As noted above, these reporting and disclosure requirements do not apply to top hat plans that make a one-time top hat filing with the DOL.)

Wells Fargo’s Response

Wells Fargo contended that the Plan did qualify as a top hat plan, and that the Plan’s vesting provisions were therefore legally permissible and properly applied. Wells Fargo also moved to have Berry’s claims about ERISA reporting and disclosure and minimum funding requirements dismissed.

Wells Fargo argued that Berry did not have legal standing to pursue a claim about breach of ERISA reporting and disclosure requirements on the theory that any supposed breach of those requirements did not cause Berry to suffer any harm alleged in his complaint. The Court ultimately found in favor of Wells Fargo and dismissed those claims.

Wells Fargo also asked the Court to dismiss Berry's claims about the alleged failure to fund the Plan, again on the theory that Berry suffered no claimed harm related to the alleged breach. The Court denied Wells Fargo's motion on this issue. Because the Plan was a defined contribution plan, and taking the claims in the light most favorable to Berry (as is required when deciding a motion to dismiss), the Court found that Berry could suffer a harm in any attempted recovery if the plan was underfunded. The Court distinguished its analysis from other cases involving underfunded defined benefit plans.

The motion to dismiss did not address the critical question about the Plan's status as a top hat plan. As a result, discovery and other procedural steps proceeded, including several attempts at mediation.

The Settlement

In October 2019, after 2-1/2 years of extensive litigation and discovery, Wells Fargo reached a \$79 million settlement (including \$20 million in attorneys' fees) with Berry and the class. The Court preliminarily approved the settlement in February 2020. A final approval hearing was scheduled for June 15, 2020.

The settlement amount of \$79 million represents a recovery of approximately 30% of the total amount of forfeitures by members of the settlement class.

In approving the settlement as fair to the class members, the Court noted the difficulty in determining whether a plan qualifies as a top hat plan given the absence of a statutory or regulatory bright-line test. The plaintiff's memorandum in support of the settlement recounted the various disagreements of the parties over the quantitative and qualitive elements involved in making in the top hat determination. For example, the parties disagreed over what the denominator should be when measuring the percentage of the total workforce eligible to participate in the plan. Berry argued the denominator should be only employees of Wells Fargo Advisors, LLC (approximately 25,000 employees), while Wells Fargo contended that the denominator should be all employees of Wells Fargo & Company and its affiliates (approximately 275,000 employees). The memorandum observed that there is case law supporting both arguments. The parties also disagreed over how to calculate the ratio to determine the compensation disparity between participants and non-participants. The memorandum noted that the Plan included language clearly indicating the intent that it be considered a top hat plan, and though some courts have found this language not to be dispositive of a plan's legal status, other courts have given this statement much weight in making the top hat determination.

Ultimately, the Court recognized that a settlement at about 30% of the forfeited amounts was fair to the class members given the challenges in contesting the Plan's top hat status in light of the unclear statutory definition and inconsistent court holdings.

Lessons Learned

When designing NQDC plans, employers should carefully consider (i) whether the plan is a "pension plan" under ERISA, and (ii) if so, whether it will qualify as a top hat plan.

Assuming a NQDC plan is intended to be a top hat plan, care should be given when determining who is eligible to participate in the plan. As illustrated by the $79 million settlement in *Berry*, a lot can be at stake. The employer should consult with their attorneys to better understand the court decisions in their jurisdiction addressing the top hat analysis.

Below are a few general questions that employers may want to consider when evaluating whether their plan qualifies as a top hat plan:

- How many employees, as a percentage of the entire workforce, will be eligible for benefits under the plan? Generally having less than 10% of participant will not raise any red flags.
- What is the average compensation of the employees eligible for the plan compared to the workforce as a whole? Generally, employees eligible for the plan should have average compensation in excess of two-times the average compensation of the entire workforce.
- Is there anyone eligible for the plan who clearly would not appear to be in management or highly paid (such as an executive assistant)? If so, this should be closely reviewed and consideration given to excluding those individuals.
- Does the NQDC plan include language clearly expressing the employer's intent that the plan be treated as a top hat plan?

The employer should also make sure that it timely makes the one-time DOL top hat filing for the plan.