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ERISA Forfeiture Litigation: The New Frontier

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There have been important developments from the Internal Revenue Service (IRS) as well as pending court cases regarding the proper use of forfeitures which arise under defined contribution plans, such as 401k plans. These developments present potential conflicts and liabilities that employers and fiduciary committees need to be aware of and review. These issues should be discussed with ERISA counsel and consideration should be given to the "next steps" and "the key decision" discussed below.

FORFEITURES

Forfeitures occur when employer contributions, e.g., profit-sharing or matching contributions, are not fully vested when a participant terminates employment. As an illustration, if a 401(k) plan applies a six-year graded vesting schedule to profit sharing contributions, and a participant terminates employment prior to achieving six years of vesting service,

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the non-vested portion of the participant's profit sharing account is subject to forfeiture.

The exact timing of when the non-vested portion of an account becomes a forfeiture is dictated by the plan document. Generally, the non-vested portion can be forfeited as of the earlier of (i) the date the participant incurs five consecutive one-year breaks in service (or five consecutive years of separation if the elapsed time method for calculating vesting service is used), or (ii) the date the participant takes a complete distribution of the vested portion of their account balance. If the plan allows forfeitures to arise when the participant takes a complete distribution, the plan must also allow reinstatement of the forfeited amount if the participant becomes reemployed before incurring five consecutive one-year breaks in service (or five consecutive years of separation) and repays the vested amount that was previously distributed.[1]

IRS GUIDANCE

There are several provisions of the Internal Revenue Code (the Code) that address forfeitures in defined contribution plans.

First, Code Section 401(a)(7) requires qualified plans to comply with the rules set forth under Code Section 411(a). Generally, Section 411(a) provides that an employee's right to employer contributions must become nonforfeitable after a specified period of service. It also provides exceptions to this general rule, conditions under which forfeitures must be restored, and other related rules.

In addition, Code Section 414(i) provides that a defined contribution plan must provide benefits that are based solely on the amount contributed to the participant's account, plus any income, expenses, gains, losses and forfeitures allocated to the account.

In February 2023, the IRS issued proposed regulations providing guidance as to how and when forfeitures arising in defined contribution plans may be used.[2] Under the proposed regulations, forfeitures may be used as follows:

(i) To pay expenses that can be properly charged to the plan;

(ii) To reduce employer contributions under the plan; or

(iii) To increase benefits by being allocated to participant accounts.[3]

The proposed rules provide that the deadline for using forfeitures is twelve months after the close of the plan year in which they were incurred.[4] For example, forfeitures incurred in 2024 must be used by December 31, 2025. If finalized, the proposed regulations will become effective on January 1, 2024, but plan fiduciaries are permitted to rely on

them in the meantime. Further, it is important to note that a transition clause set forth in the proposed regulations permits a plan to use up old forfeiture balances (accumulated prior to January 1, 2024) by December 31, 2025.[5]

It also should be noted that the IRS proposed regulations do not prohibit a plan from specifying only one use for forfeitures or mandating that forfeitures be used in a particular order. Thus, a plan could require that forfeitures only be used to reduce employer contributions, or to reduce employer contributions and then, if any remain, to pay plan expenses.

DEPARTMENT OF LABOR (DOL) GUIDANCE

The DOL has not issued formal regulatory guidance regarding the use of forfeitures, and has not addressed whether forfeitures are plan assets under ERISA that must be used for the exclusive purpose of providing benefits to participants and defraying reasonable expenses of plan administration.[6]

Most practitioners assume that the DOL agrees with the IRS rules that forfeitures can be used either to pay plan expenses or reduce employer contributions. However, on September 28, 2023, the DOL issued a news alert indicating that ERISA fiduciary duties could apply to the use of forfeitures.[7] In that news report, the DOL announced that it had ordered a company, Sypris Solutions Inc., to restore $575,000 to its 401(k) plan participants due to the company's improper use of forfeitures. The plan document specifically required that forfeitures be used to pay plan expenses, but the company used forfeitures to reduce employer contributions. The DOL ordered the company to restore $575,000 not only because it had failed to follow the terms of its plan document, but also apparently because it acted in a manner that benefited itself at the expense of plan participants whose account balances were charged the plan expenses. The DOL could have announced that their penalty was assessed simply because of Sypris' failure to follow plan terms in contravention of ERISA, but it chose not to do so.

LITIGATION

Recently, plaintiff attorneys have initiated several lawsuits that challenge how 401(k) plan sponsors use forfeitures. As of the writing of this column, companies that have been sued include Qualcomm, Intuit, Clorox, Thermo Fischer, Honeywell, HP, Mattel and John Muir Health. In nearly every lawsuit, the plans permitted forfeitures to be used to pay administrative expenses or reduce future employer contributions, as permitted by the IRS regulations. In nearly each case, the forfeitures were used to reduce employer contributions rather than pay plan expenses,

which were ultimately charged to participant accounts. The plaintiff attorneys allege that the plan fiduciaries breached their ERISA fiduciary duties by using the forfeitures in this manner, i.e., for the benefit of the employer rather than the participants. As stated in the Clorox complaint: "[d]efendants chose to use these Plan assets for the exclusive purpose of reducing its own future contributions to the Plan, thereby saving the Company millions of dollars at the expense of the Plan which received decreased Company contributions and its participants and beneficiaries who were forced to incur avoidable expense deductions to their individual accounts."[8]

In addition, the plaintiffs alleged that the defendants' use of forfeitures to reduce employer contributions resulted in direct and self-dealing prohibited transactions.

As damages, plaintiff attorneys have sought, among other things:

(i) Restoration to the plan of amounts used to offset employer contributions;

(ii) Disgorgement of profits; and

(iii) Attorneys' fees.

The plaintiff attorneys bring these claims despite the IRS proposed regulations and the routine practice of plans allowing the discretionary use of forfeitures to reduce employer contributions. An examination of the complaints filed in these cases shows plaintiffs' theories of liability, including those discussed below.

Plaintiffs assert that the defendants, as fiduciaries under ERISA, were required to discharge their duties "solely in the interests of the participants and beneficiaries"[9] and "for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan."[10] They allege that the defendants breached these duties by using plan forfeitures for their own benefit, i.e., by reducing the company's employer contributions to the Plan which saved the company millions of dollars each year. By acting in this manner, plaintiffs also allege that the defendants breached Section 403(c)(1) of ERISA which requires that the assets of a plan "shall never inure to the benefit of any employer and shall be held for the exclusive purpose of providing benefits to participants in the plan and their beneficiaries."

Plaintiffs also assert that the defendants, as fiduciaries, were required to act in accordance with ERISA's prudent man standard, i.e., with the "care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[11] They allege that the defendants

breached this fiduciary duty by failing to engage in a prudent decision-making process which focused on whether participants would be better served by using forfeitures for something besides reducing employer contributions.

Finally, plaintiffs assert that defendants caused their plan to engage in a direct or indirect transaction with a party interest and dealt with plan assets for their own account in contravention of ERISA sections 406(a)(1) and 406(b).

In motions to dismiss, the fiduciary defendants have countered with various arguments, including those set forth below.

First, the defendants argue that the lawsuits fail to state a claim for an ERISA violation because their conduct of reallocating forfeitures to reduce employer contributions has been commonplace since at least 1963 and the practice has been directly or indirectly endorsed by Congress, the IRS and the DOL. Further, the plan's governing documents allow for this practice and no provision of the plan entitles any participant to contributions which have been forfeited by other participants.

Second, the defendants argue that the plaintiffs lack standing to pursue their claim, since they do not allege that plan accounts received less than was promised under the plan or that the accounts suffered losses or lost profits due to the fiduciaries' decisions. The fiduciaries assert that, in fact, defendants have not suffered any injury because they have received all of the benefits they were promised under the Plan.

Third, the defendants challenge plaintiffs' arguments on the merits, stating that the IRS regulations allow forfeitures to reduce employer contributions and permit them to be used to pay plan expenses, but neither the regulations nor the plan document requires either application. In addition, fiduciaries note that ERISA specifically provides that it does not supersede or impair other federal laws, such as the Code.

Fourth, the defendants assert that plaintiffs cannot establish that defendants were acting as fiduciaries while engaging in the alleged prohibited conduct. At most, the defendants were acting as "settlors" (i.e., non-fiduciaries) when declining to use forfeitures to pay plan expenses.

Finally, with respect to the plaintiffs' prohibited transaction claims, the defendants assert that these claims should fail because reallocating forfeitures to reduce employer contributions within the same plan does not constitute a prohibited "transaction" nor prohibited self-dealing.

NEXT STEPS

The starting point for employers and fiduciary committees is to review the forfeiture provisions of their plan document to gain a thorough understanding of how it treats forfeitures. The plan document should outline how forfeitures are managed. Terms and provisions should be unambiguous and not lead to misinterpretation. The plan document

should allow forfeitures to be used promptly, e.g., within 12 months after the plan year in which they are created. If there has been a delay in using forfeitures in the past, consideration should be given to using the transition period set forth in the proposed regulations to use these forfeitures by December 31, 2025.

It is recommended that employers and fiduciary committees meet with their ERISA counsel to review their plan forfeiture language and determine whether any amendments should be adopted to enhance their defense of future forfeiture litigation. For example, employers may want to delete their discretionary language regarding the use of forfeitures and, instead, mandate the use of forfeitures to reduce employer contributions and then pay plan administrative expenses if any forfeitures remain. At a minimum, employers and fiduciary committees should consider following the IRS proposed regulations and ensure their plans are operated in accordance with governing documents. Engaging ERISA counsel to monitor litigation and other developments in this area is also a wise practice.

Lastly, it is important for employers and fiduciary committees to understand which plan administrative expenses may be paid with forfeitures and which need to be paid with corporate assets. In all cases, plan sponsors must keep records of their plan's forfeitures to demonstrate compliance with the law and applicable terms of the plan.

THE KEY DECISION

Most plans it seems allow forfeitures to be used to pay plan expenses or to reduce employer contributions. It also seems that many plan fiduciaries choose to use forfeitures to reduce employer contributions, rather than pay plan expenses which are charged to participant accounts. This choice is at the heart of the recent litigation. Plan fiduciaries, therefore, may wish to consider amending their plan to eliminate the choice. That is, to mandate that forfeitures first be used to reduce employer contributions and then, if any are left over, to pay plan expenses.

Amending a plan in this manner would not eliminate the possibility of a lawsuit, as the ERISA statute of limitations is generally six years.[12] Thus, a plaintiff could theoretically sue plan fiduciaries for the allegedly improper use of forfeitures prior to the effective date of the amendment. However, such an amendment would likely protect plan fiduciaries going forward, although plaintiffs could mount challenges to the amendment based on any number of theories, including that the plan amendment itself breaches ERISA.

CONCLUSION

Although common perception is that the lawsuits described above will not be successful, it remains to be seen what will come of them. Clearly, guidance issued by the IRS allows forfeitures to be used to reduce employer contributions or pay eligible plan expenses, at the discretion of the plan sponsor. A court decision altering this practice would be a profound change. But, as anyone who follows ERISA litigation knows, profound changes sometimes occur. To address the lawsuits, plan fiduciaries should convene with their ERISA counsel to review their procedures for handling forfeitures and to consider amending their plan to remove discretion over forfeiture use.

Notes

1. Internal Revenue Code (IRC) Section 411(a)(3)(D).
2. 88 Fed. Reg. 12282 (February 27, 2023).
3. Prop. Treas. Reg. Section 1.407-1(b)(1).
4. Id. at 1.407-1(b)(2).
5. Id. at 1.407-1(c).
6. ERISA Section 403(c)(1); IRC Section 401(a)(2).
7. "Federal Court Orders Louisville Technology Services Provider, Retirement Savings Plan To Repay $575k To Plan Participants," www.dol.gov/newsroom/releases/ebsa/ebsa20230928 (September 28, 2023).
8. McManus v. Clorox Co., N.D. Cal., No. 4:23-cv-05325, complaint 10/18/23.
9. ERISA Section 404(a)(1).
10. ERISA Section 404(a)(1)(A).
11. ERISA Section 404(a)(1)(B).
12. ERISA Section 413.

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