

Retirement Plan Forfeitures - A New Wave of Class Action Litigation



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Over the past year, a flurry of class action lawsuits alleging misuse of retirement plan forfeitures have been filed against major U.S. retirement plans and their fiduciaries. Starting in September 2023, a plaintiff's law firm filed a putative class action lawsuit against Thermo Fisher Scientific, Inc., in the Southern District of California, which alleged that Thermo Fisher retirement plan fiduciaries breached their duties, violated ERISA's anti-inurement provision and engaged in prohibited transactions by using plan forfeitures to offset employer matching contribution obligations instead of paying down plan administrative costs otherwise payable by plan participants. Although using forfeitures to offset employer contributions has been expressly allowed under U.S. Treasury rules for decades, the plaintiffs in *Thermo Fisher* asserted the novel theory that doing so violated ERISA's fiduciary duties of loyalty and prudence.

Since that time, approximately 15 similar lawsuits have been filed by several plaintiffs' law firms across the country against major defendants including Intuit, Clorox, Qualcomm, HP, BAE Systems, Wells Fargo, Bank of America, Nordstrom, Siemens, Albertsons and Tetra Tech. Most of these lawsuits are in California, but plaintiffs have also brought suit in Washington, Virginia, New Jersey and Arizona.

In this article, we begin with an overview of plan forfeitures and their treatment by various government agencies. We then assess the claims and allegations in the complaints, arguments that defendants have made in seeking dismissal of the lawsuits, and initial court rulings on defendants' motions to dismiss. We conclude with action items that plan fiduciaries should consider in order to mitigate the risk of a future lawsuit.

Background

A forfeiture occurs when an employee leaves their company before the employer's matching contribution fully vests (typically the result of either a cliff or graded vesting schedule). The non-vested balance of the employer's matching contributions in the participant's account is forfeited and subsequently held in a separate plan forfeiture account. As has long been approved by the IRS (and as contemplated in proposed Treasury regulations), forfeitures may (at least as a tax qualification matter) be allocated to one of three uses: (1) offsetting employer matching contributions; (2) defraying plan expenses; or (3) providing additional benefits to participants. Most of the plans in the lawsuits discussed in this article place the decision of how to allocate forfeitures, among those options, within the discretion of the plan administrator. Other plans remove any discretion and instead prescribe the order in which forfeiture funds will be allocated. As explained below, this

distinction is a key factor in determining whether plan fiduciaries may be subject to fiduciary liability in connection with their handling of plan forfeitures, as the exercise of discretion renders the decision fiduciary in nature, and thereby more susceptible to a fiduciary breach claim.

Providing plan fiduciaries with the option of how to use forfeiture funds has long been recognized by the IRS, as well as by Congress and the Department of Labor (DOL), as several defendants in these cases have argued. In addition to the pending regulation noted above, the IRS has long acknowledged the validity of this three-part scheme, including in a 2010 IRS Newsletter and sections of the Internal Revenue Manual from February 2017. Additionally, 2018 Treasury regulations permitted forfeitures to be used to fund qualified employer matching contributions (QMACs) and qualified non-elective contributions (QNECs) in order to satisfy non-discrimination testing. Indeed, as far back as 1963, the IRS issued a regulation stating that retirement plan providers must use forfeited assets “as soon as possible to reduce the employer’s contributions under the plan,” although this regulation likely applied in the pension plan context.

Congress likewise acknowledged the propriety of using forfeitures to offset employer contributions in a House Conference Report to the Tax Reform Act of 1986, and the DOL has observed on several occasions over the years (dating back to 1979) that plans allow forfeitures to be used to offset contributions without ever raising an issue with the practice. (Note: the DOL has not yet provided guidance or otherwise weighed in on whether the plaintiff’s fiduciary breach allegations in these cases have merit.)

Plaintiffs’ Claims

Notwithstanding the longstanding practice of plans using forfeitures to offset employer matching contributions, plaintiffs in these lawsuits (all of whom are plan participants) allege that, by using forfeitures to first offset employer contributions rather than defray plan expenses, plan fiduciaries breached their duties by failing to discharge them in the best interest of participants and for the exclusive purposes of providing benefits and defraying reasonable expenses of administering the plan, as required by ERISA § 404(a). The plaintiffs claim that forfeiture funds should first be used to pay plan expenses, before any funds are used to offset employer matching contributions. The plaintiffs contend that by failing to use forfeitures to pay plan expenses, fiduciaries cause administrative costs to increase, and ultimately to be charged to participant accounts, thereby harming participants.

In addition to claims for breach of the duties of loyalty and prudence under ERISA § 404(a), plaintiffs assert claims for co-fiduciary liability, as well as violations of ERISA’s anti-inurement provision (ERISA § 403(c), which requires that plan assets never inure to the employer) and prohibited transactions under ERISA §§ 406(a)-(b).

Defendants’ Arguments

In motions to dismiss filed in several of the pending cases, various defendants have made similar arguments. Among other things, defendants argue that the plaintiffs lack standing to sue because they have received all the benefits they were entitled to under the terms of the plan, and, therefore, have not sustained any injury-in-fact. Defendants also point to the longstanding IRS, DOL and Congressional guidance and regulations noted above, which demonstrate government approval of the use of forfeitures to offset employer contributions first. Defendants further argue that the decision of how to use forfeitures is a settlor function, and thus not subject to ERISA’s fiduciary duties.

Defendants argue that ERISA's anti-inurement rule does not apply to reallocation of funds within a plan, that forfeiture funds are not plan assets because participants have no interest in them, and that no prohibited transaction occurred because there is no transaction using plan assets with a party-in-interest. Lastly, defendants argue that the plaintiffs in effect seek to read a new benefit into ERISA – namely, the payment of plan administrative expenses – in spite of the fact that ERISA exists solely to protect existing benefits, not to create new ones.

Motions to Dismiss

To date, courts have issued six decisions relating to defendants' motions to dismiss. Two have denied the motions (*Qualcomm* and *Intuit*), while four have granted the motions (*Thermo Fisher*, *Clorox*, *HP*, *BAE Systems*), at least in part.

In *Qualcomm* and *Intuit*, both courts employed similar reasoning in denying the defendants' motions to dismiss. Both courts found that, even though the plan sponsors may have complied with the plan's terms by using forfeitures to reduce their own matching contributions, the plaintiffs plausibly alleged that this decision was a breach of ERISA's duty of loyalty that "harmed the participants by letting the administrative expense charge fall on the participants rather than the employer." The *Qualcomm* court noted that, had the defendants used the forfeited contributions toward paying plan administrative expenses, all participants would have benefited by incurring no administrative expense charge, but instead all participants "had to pay for administrative expenses that could have been reduced to zero had the Defendants chosen to use forfeited contributions in that way."

By contrast, four courts have ruled in favor of defendants, dismissing plaintiffs' complaints, usually with leave to amend. Courts in this camp have found that the plaintiffs' claims are implausibly overbroad – as the *HP* court noted, a "swing for the fences" – because they purport to create a new benefit in the form of payment of plan administrative expenses, despite the presence of plan language to the contrary. These courts have been unwilling to extend the protections of ERISA beyond its statutory framework in order to create a new benefit. Moreover, contrary to the *Qualcomm* and *Intuit* courts, these courts found that ERISA's anti-inurement and prohibited transaction provisions were not applicable to intra-plan transfers of forfeiture funds.

One key area these courts agree on in the plaintiff's favor is that, where a plan provides fiduciaries with discretion of how to use forfeitures, that decision is a fiduciary act that can expose the fiduciaries to liability (however, in this set of cases, the courts found that the plaintiffs failed to allege that this exercise of fiduciary authority caused a breach). In the *BAE Systems* case, the court importantly found that no fiduciary act occurred because the terms of the plan contained mandatory language that required employer contributions to be offset first. As such, the choice of how to use forfeitures was a settlor decision, not fiduciary in nature, and could not give rise to a breach. Note, however, if a court were to determine that a plan *itself* violated ERISA in relation to the use of forfeitures, the defendants would not be able to rely upon the plan's provisions, and would still be exposed to a claim for breach of fiduciary duty.

Practical Considerations

It is not yet clear how much traction these cases will ultimately gain. Nevertheless, given the initial success of the plaintiffs in the *Qualcomm* and *Intuit* cases, as well as the prospect that amended complaints may yet pass the motion to dismiss threshold in other courts, plan sponsors would be wise to keep an eye on this growing litigation trend. In addition, plan sponsors may take certain steps to reduce potential fiduciary risk, including:

- Consider amending the plan document to remove discretion as to use of forfeitures
- Review the plan document, summary plan description and communications with participants regarding the plan's forfeiture procedures, and ensure procedures are outlined consistently
- Audit vesting and forfeiture processes to confirm compliance with the plan's procedures
- Review Forms 5500 regarding discussion of plan forfeitures, as plaintiffs are using these in order to evaluate possible claims
- Review service provider agreements relating to the use of forfeitures
- Consider requiring plan to require forfeitures be used to pay plan expenses first
- Where a plan provides discretion in the use of forfeitures, document the decision-making process relating to forfeitures, and consider hiring an independent fiduciary to evaluate forfeiture use

If you have questions regarding the potential fiduciary risk associated with the use of retirement plan forfeitures, please contact us.

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