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Emerging Litigation on Use of Forfeited Retirement Contributions: What is in the Best Interests of Plan Participants?

Vesting periods for defined contribution plans incentivize employee retention and ensure that employers' money is invested in loyal employees. When employees terminate employment early, forfeitures resulting from non-vested contributions grant employers the opportunity to reinvest these funds back into retirement plans. Recently, employers' common practice of using forfeitures to reduce their future employer contributions to the plan has faced scrutiny and become the subject of numerous lawsuits. This litigation, while previously dismissed at earlier stages in litigation, is now making its way through the cracks.

What Are Forfeitures and How Are They Used?

Employer-sponsored defined contribution plans, such as 401(k) and 403(b) plans, are retirement plans funded by contributions from both the employee and the employer. An employee may contribute a portion of their paycheck to the plan, up to the employee contribution limit set by the Internal Revenue Service ("IRS"). Many employers then match a certain percentage of these employee contributions or make a separate discretionary contribution on behalf of all employees. Employer contributions are typically subject to a vesting period, which specifies the duration that must pass before the employee has a right to 100% of the employer's contributions. If an employee leaves the company before contributions have fully vested, any non-vested contributions made by the employer are relinquished by the employee and deemed a "forfeiture."

Plan sponsors must use forfeitures pursuant to the rules set forth in their plan documents and in compliance with IRS and ERISA guidelines. Plan sponsors often take advantage of one of three common forfeiture uses: (1) to offset reasonable plan expenses; (2) to offset future employer contributions; and (3) to reallocate to current employee participants. In 2023, the IRS issued a proposed regulation permitting all three of these forfeiture uses in an attempt to make these long-standing practices legally permissible under regulation.

Emerging Litigation on the Matter

For decades, plan sponsors have utilized forfeitures to offset future employer contributions. Despite an acceptable and widely followed practice, recent litigation has alleged that this use of forfeitures fails to comply with fiduciary requirements under ERISA. Lawsuits are surfacing against plan sponsors who elected to offset future contributions rather than minimize the administrative expenses of current

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participants or allocate the forfeitures as an additional contribution, claiming these plan sponsors are acting as fiduciaries of the plan and are liable under ERISA for breaching their fiduciary duties of loyalty. The duty of loyalty requires a fiduciary to act solely in the best interests of participants and beneficiaries when providing benefits and defraying reasonable administrative expenses. Participants in pending lawsuits have argued that in choosing to use forfeitures to reduce employer contributions rather than using them to reduce the plan's administrative expenses or allocate them as an additional contribution, the fiduciaries have acted in the best interests of the employer and not the participant, thereby breaching their fiduciary duties under ERISA.

Multiple class action lawsuits have been filed against plan sponsors regarding their practice of allocating forfeitures. Expectations that these cases would not survive the motion to dismiss stage are quickly adjusting in light of a May 2024 decision in the Southern District of California. In *Perez-Cruet v. Qualcomm, Inc*., the plaintiff, a current participant in Qualcomm's defined contribution plan, alleged that as managers of the plan, the defendants violated ERISA when choosing to use forfeited plan contributions to offset future Qualcomm contributions rather than defray the administrative expenses of the plan for current plan participants. The plaintiff claimed breach of fiduciary duty of loyalty, breach of fiduciary duty of prudence, breach of ERISA's anti-inurement rule, use of forfeitures as a prohibited transaction, and failure to monitor fiduciaries. The court found each of the plaintiff's claims plausible at the pleading stage, denying the motion to dismiss on all claims, and pushing the lawsuit into the next stage of litigation. Less than one month later, a case nearly identical to *Qualcomm* was also heard at the motion to dismiss stage. In *Hutchins v. HP Inc*., the U.S. District Court for the Southern District of California granted all motions to dismiss. These conflicting verdicts demonstrate how uncertain the legal landscape is surrounding forfeiture allocation.

What Can You Do To Avoid Litigation?

Plan sponsors and fiduciaries should review their plans' terms to ensure that their plans are currently being administered in accordance with their terms. If a plan establishes that forfeiture utilization is based on plan discretion, the company should ensure that these decisions are being prudently documented. Employers should also consider adjusting a plan's administration of forfeiture use to eliminate any risks of fiduciary breach under ERISA.

Employers and plan sponsors should consider amending their plans to definitively state how forfeitures are to be utilized and eliminate any discretionary authority that may be subject to fiduciary duties under ERISA. However, the lack of flexibility to use forfeitures as needed based on circumstances may be confining and undesirable for some employers. An alternative approach is to amend the plan or otherwise clearly articulate that the employer is making the decision on how to use forfeitures as the "plan sponsor" and not as a "fiduciary" of the plan.

Our Employee Benefits and Executive Compensation group is available to assist with a review of your retirement plan documents and to address any questions about using forfeitures under your plan.