VOLUME 79 ◆ NUMBER 3

Employee Benefit Plan Review

An Emerging Trend in ERISA Class Action Litigation: 401(k) Forfeiture Suits

By Monica I. Perkowski, Kayla Leland Pragid, Lindsey R. Camp and Todd D. Wozniak

There has been a recent uptick in ERISA class actions challenging the use of 401(k) plan forfeitures. Forfeitures are employer contributions that participants forfeit when they leave employment before those contributions vest (i.e., before the monies are guaranteed to the employee). Historically, these forfeited monies stay in the 401(k) plan. Although the use of forfeitures to offset future employer contributions has been a longstanding practice allowed under regulatory guidance, plaintiffs are asserting a novel theory that doing so violates several provisions of ERISA. So far, there have been more than 30 401(k) forfeiture lawsuits filed against companies of all sizes. These cases are still in their early stages with none reaching final judgment and only a handful of mixed decisions on motions to dismiss.

Given the infancy of these novel theories and a largely unsettled legal landscape, it is paramount for plan sponsors and fiduciaries to implement risk mitigation strategies now. This includes at a minimum, evaluating their plan's forfeiture terms and ensuring that the use of plan forfeitures is consistent with plan terms.

What Are 401(k) Plan Forfeitures?

Under ERISA, participants in defined-contribution plans are always fully vested in their own contributions. However, this is not necessarily so with employer contributions, which may be subject to a vesting schedule. Forfeitures typically occur when an employee leaves a company before becoming fully vested in employer contributions in the 401(k) plan made on the employee's behalf.

The U.S. Department of the Treasury has addressed how ERISA-covered defined benefit pension plans may handle forfeitures, stating forfeited amounts "must be used as soon as possible to reduce the employer's contributions under the plan."[1] In 2023, the Treasury Department reaffirmed its position and proposed another regulation regarding defined contribution plan forfeitures, including 401(k) plans forfeitures, which would permit the forfeited employer contributions to be used for three purposes "as specified in the plan: (1) to pay plan administrative expenses, (2) to reduce employer contributions under the plan, or (3) to increase benefits in other participants' accounts in accordance with plan terms."[2] The 2023 proposed regulation, if adopted, would continue to allow the decades-long practice of using forfeitures to offset future employer contributions.

ERISA is silent regarding the permitted use of forfeitures, and the U.S. Department of Labor (DOL) – which is tasked with primary enforcement of ERISA – has never asserted that the use of forfeitures to offset future employer contributions violates ERISA.[3]

The Parties' Arguments

Despite clear regulatory guidance, recent class actions allege a new liability theory that employers and 401(k) plan fiduciaries have breached their fiduciary duties of loyalty and prudence under ERISA by using forfeited employer contributions in this manner instead of using those forfeitures to offset routine 401(k) plan expenses that were charged to participant accounts. Plaintiffs essentially argue that using forfeitures to offset future employer contributions prioritizes the employer's financial interests over the best interests of plan participants and thus violates ERISA. Plaintiffs also allege that this practice: (1) violates ERISA's anti-inurement provision because using forfeitures to offset future employer contributions causes plan assets to "inure" to the benefit of the employer, not participants, and (2) constitutes an ERISA-prohibited transaction because it amounts to self-dealing by reducing the amount of contributions an employer has to make to the plan.

Defendants have argued that these claims fail as a matter of law based on six primary arguments.

The first is that using forfeitures to reduce employer contributions is permitted by both current regulations and the 2023 proposed Treasury Department regulation.

Second, ERISA does not require employers to offer any particular benefits, including employer 401(k) contributions. Indeed, plan sponsors are entitled to decide what level of benefits they provide, how to fund them and which plan-related costs participants will bear. As such, if employers cannot use forfeitures to reduce future employer contributions, employers may decide not to make any employer contributions because they are not legally required to do so.

Third, decisions related to plan terms, including how a plan will be funded, whether to make employer contributions and whether to charge expenses to the plan, are all decisions related to plan design made in a settlor capacity and not in a fiduciary capacity. Settlor functions, such as plan design, cannot form the basis of a breach of fiduciary claim.

Fourth, plan sponsors are not liable for breaching their fiduciary duties insofar as they followed lawful plan terms that expressly permitted the plan to use forfeitures to offset employer contributions.

Fifth, with respect to the claim by plaintiffs that the defendants are violating ERISA's anti-inurement provision, the defendants point out that forfeitures are not removed from the plan, but instead remain in the plan to be reallocated to other participants who are provided with benefits. This is not self-interested conduct on the part of plan sponsors and is consistent with ERISA.

Finally, the use of forfeitures to offset employer contributions does not qualify as a "transaction" as that term is used in ERISA Section 406(a) and, thus, the plaintiffs' prohibited transaction claim fails.

The Current Status of the Litigation

It is too early to determine where courts will ultimately land, but so far, there have been mixed decisions on whether such class action complaints can survive a motion to dismiss.

In May 2024, the U.S. District Court for the Southern District of California denied the defendants' motion to dismiss in the first decision in the 401(k) forfeiture cases.[4] In this case, the plan gave the company the "discretion" to use forfeitures to reduce employer contributions or to pay plan administrative expenses.[5] The court held that the plaintiff "plausibly" alleged the defendants breached their fiduciary duties in exercising their discretion in favor of reducing employer contributions rather than paying expenses and thus "harm[ing] the participants" by "letting the administrative expense charge fall on the participants rather than the employer."[6] Applying similar reasoning, the court determined that the plaintiff adequately pled claims for breach of ERISA's anti-inurement and prohibited transactions provisions.[7]

Other courts took the opposite approach and granted the defendants' motions to dismiss, with the most recent decision coming in December 2024.[8] In those cases, the courts held the plaintiffs' theory of liability was too broad to be plausible. The courts rejected the plaintiffs' argument that any time a plan administrator has the option, pursuant to the plan document, to use forfeitures to either reduce employer contributions or to pay administrative costs, it must choose the latter or else it violates its fiduciary duties under ERISA.[9] In these cases, the courts' focus, among other things, has been on the discretionary authority granted to plan fiduciaries in plan provisions discussing permitted uses of forfeitures. For example, in a case filed in the U.S. District Court for the Northern District of California, the plan at issue provided that "forfeited amounts may be used to 'reduce employer contributions, to restore benefits previously forfeited, to pay Plan expenses, or for any other permitted use.'"[10] In rejecting the plaintiff's theory of liability as too broad and thus "implausible," the district court noted that the plaintiff's theory "would require any fiduciary to use forfeited amounts to pay administrative costs regardless of … context or circumstances," including any discretionary authority granted to a fiduciary by a plan.[11] According to the district court, the plaintiff's theory of liability would "improperly extend the protection of ERISA beyond its statutory framework" by effectively creating a benefit (i.e., the payment of administrative costs) not provided by the plan.[12]

In another case, plaintiffs alleged a violation of ERISA where the plan document mandated, without conferring any discretion to the fiduciary, that forfeitures be used to reduce employer contributions.[13] The district court rejected this argument as contrary to the plan terms.[14]

As for plaintiffs' claims for violations of ERISA's anti-inurement provision, some courts have dismissed those claims finding that the forfeitures never left the plan trust fund and were used to pay pension benefits to participants. The fact that the employers benefited through a reduction in their future matching contributions was only "incidental to the payment of pension benefits."[15]

Likewise, some courts have dismissed ERISA prohibited transaction claims made by plaintiffs because the payment of benefits was not a "transaction," as this term is defined in ERISA Section 406(a).[16] Moreover, the courts found that the plaintiffs' allegations were insufficient because they did not allege any facts indicating the reallocation of the forfeited amounts exposed the plan to "a special risk of plan underfunding," as is required to plead a prohibited transaction claim.[17]

In Summary

- Since the fall of 2023, plaintiffs have filed more than 30 class action lawsuits alleging that the use of 401(k) forfeitures to offset future employer contributions violates several Employee Retirement Income Security Act (ERISA) provisions, including the fiduciary duties of loyalty and prudence and ERISA's anti-inurement provision. Plaintiffs have also alleged that this practice constitutes a prohibited transaction under ERISA.
- Despite clear guidance from the U.S. Department of the Treasury acknowledging the propriety of using 401(k) forfeitures to offset future employer contributions and the decades-long practice of doing so, plaintiffs have gained traction with some courts on this novel theory.
- Although these class actions remain in their infancy, a handful of decisions on motions to dismiss offer insight into how courts are viewing these claims and highlight the importance of reviewing forfeiture provisions in plan documents to ensure that the use of forfeitures is consistent with plan terms and applicable laws.

Conclusions and Considerations

Although the 401(k) forfeiture litigation is still in its early stages, recent decisions on motions to dismiss offer important insights into how courts are viewing the claims and defenses. A common theme is the importance of plan provisions that detail the permitted or mandated uses of forfeitures. As these cases continue to develop beyond the pleadings stage, employers and plan fiduciaries should be proactive in reviewing their plan language to determine whether changes would strengthen their defense in case of any potential or future litigation. For example, plan sponsors should consider whether to remove from the plan language any discretion regarding the use of forfeitures. Plan sponsors may also consider whether to amend their plan to specify that forfeitures must first be used to reduce employer contributions, and then, if any forfeitures remain, those must be used to pay administrative expenses.

Another important risk mitigation step to keep in mind is to ensure transparent communications with participants on the use of forfeitures – including clearly communicating the forfeiture process and how forfeitures are to be used – through the plan document, summary plan description and other plan communications.

Finally, plan sponsors should consider conducting regular audits to ensure that the forfeitures are being used in accordance with the plan document and applicable law.

Notes

1. 26 C.F.R. § 1.401-7(a).
2. Use of Forfeitures in Qualified Retirement Plans, 88 Fed Reg. 12282-01 (Feb. 2023).
3. Although the DOL has remained silent on this particular issue, it did bring one suit involving forfeitures. In 2017, the DOL sued a plan sponsor alleging that its use of forfeitures to reduce employer contributions was contrary to the plan document and constituted a breach of fiduciary duties and a prohibited transaction under ERISA. Case No. 3:17-CV-784-BJB (W.D. Ky 2017). The case settled in 2023.
4. See Case No. 23-CV-1890-BEN (MMP), 2024 WL 2702207 (S.D. Cal. May 24, 2024), reconsideration denied, 2024 WL 3798391 (S.D. Cal. Aug. 12, 2024).
5. Id. at *2.
6. Id. at *2-3.
7. Id. at *3-7.
8. Case No. 24CV4529 (EP) (JRA), 2024 WL 5165330 (D.N.J. Dec. 19, 2024).
9. Id. at *5; see also 737 F. Supp. 3d 851, 862 (N.D. Cal. 2024); Case No. 4:23-CV-05325-YGR, 2024 WL 4944363, at *6 (N.D. Cal. Nov. 1, 2024); Case No. 23-CV-1732 TWR (JLB), 2024 WL 4508450, at *9 (S.D. Cal. Sept. 19, 2024).
10. 737 F. Supp. 3d 851, 856-57 (N.D. Cal. 2024).
11. Id. at 862.
12. Id. at 863; see also 2024 WL 5165330, at *4; 2024 WL 4944363, at *6; 2024 WL 4508450, at *9.
13. Case No. 1:24-CV-00536 (AJT/WEF), 2024 WL 4112322, at *6 (E.D. Va. Sept. 5, 2024).
14. Id.
15. 737 F. Supp. 3d at 866; see also 2024 WL 5165330, at *6; 2024 WL 4508450, at *10; 2024 WL 4944363, at *7; but see No. 23-CV-05053-PCP, 2024 WL 3755367, at *8 (N.D. Cal. Aug. 12, 2024) (denying motion to dismiss claim that the defendant violated ERISA's anti-inurement provision).
16. 2024 WL 5165330, at *7; 737 F. Supp. 3d at 867-68; 2024 WL 4508450, at *11; 2024 WL 4944363, at *8.
17. 2024 WL 5165330, at *7; 737 F. Supp. 3d at 867-68; but see 2024 WL 3755367, at *10 (denying motion to dismiss claim that the defendant engaged in an prohibited transaction under ERISA).

The authors, attorneys with Holland & Knight LLP, may be contacted at monica.perkowski@hklaw.com, kayla.pragid@hklaw.com, lindsey.camp@hklaw.com and todd.wozniak@hklaw.com, respectively.