A Fiduciary Focus on Forfeitures

Roughly a year ago, a pair of attorneys located in Pasadena, California launched the first of what would become a series of lawsuits targeting the use of plan forfeitures to offset employer contributions as a breach of fiduciary duty. Though widely discounted initially, several lawsuits have now progressed beyond a motion to dismiss. Critically, those same allegations have now been made by other law firms and have recently been asserted as an additional claim alongside the more traditional excessive fee lawsuits.

Here's What You Really Need to Know:

1. A number of lawsuits have alleged that the decision to use forfeitures to offset employer contributions was not in the best interests of participants and was therefore a fiduciary breach.

2. Several of these suits acknowledge that the plan document permits the use of forfeitures to offset employer contributions.

3. There are now unrelated excessive fee suits that include similar allegations regarding the use of forfeitures.

Though none of these cases has gone through a full trial, at least two have gotten past the motion to dismiss stage, and another case was sent to arbitration. Two cases were successfully dismissed. It is important to keep in mind that these cases are changing very fast and the status and number of each of these cases that "wins" and "loses" is quickly evolving.

Forfeitures Defined

A "forfeiture" is the non-vested portion of a former employee's account balance in the plan. Those forfeited balances can generally be used in three ways: (1) to pay plan expenses (2) to offset employer contributions, or (3) to be reallocated among remaining participant balances.

Prior informal guidance from the Internal Revenue Service (IRS) provided that forfeitures must be used or allocated in the plan year that they were incurred. In February 2023, the IRS issued proposed regulations for using forfeitures in tax-qualified retirement plans (REG–122286–18). The proposed regulations extend the deadline by which plans must use forfeitures to the end of the plan year after the plan year in which the forfeitures occurred (e.g., end of the 2025 plan year to use forfeitures generated in 2024). These proposed regulations also clarify how forfeitures may be used by the plan, which includes the three ways identified above.

A New Litigation Focus

Not quite a year ago, a pair of lawyers – Hayes Pawlenko LLP, a California-based duo that positioned themselves as an employment litigation firm "representing employees in disputes with their employers" – filed the first of what has since expanded to about a half-dozen similar suits. The suits have targeted a number of national employers – Intuit, Thermo Fisher Scientific Inc., HP, Honeywell, Clorox, Intel, Qualcomm, and Bank of America – and have all been filed in the federal district court in California.

Generally speaking, the suits argue that the plan fiduciaries "chose to utilize the forfeited funds in the Plan for the Company's own benefit, to the detriment of the Plan and its participants, by reallocating nearly all of these Plan assets to reduce future Company matching contributions to the Plan." They argue that the decision not only benefitted the company by reducing its own contribution expenses, it harmed the plan, along with its participants and beneficiaries, "by reducing future Company matching contributions that would otherwise have increased Plan assets and by causing participants to incur deductions from their individual accounts each year to cover administrative expenses that would otherwise have been covered in whole or in part by utilizing forfeited funds."

Expansion of the Forfeitures Cases

During the summer of 2024, a different personal injury law firm filed a similar suit targeting Wells Fargo & Company in the U.S. District Court for the Northern District of California. This case highlights the variety of law firms that are now targeting these practices for litigation. More recently, firms with a track record in ERISA litigation have added the decision to apply forfeitures to offset employer contributions as an additional fiduciary breach to their more "traditional" excessive fee suits. Thus far, a half dozen of these suits have been filed – all targeting multi-billion dollar plans.

In short, the use of forfeitures for any purpose other than reallocating them to participant accounts, or in some cases offsetting expenses such as recordkeeping or other reasonable and necessary plan expenses (that would be charged against participant accounts), would seem to be vulnerable to suit. Recent litigation suggests that those allegations might be only one of several issues challenged.

What's Being Challenged

The arguments made in these suits are that choosing to use the forfeitures to offset employer contributions, even when permitted by the plan document, was effectively self-dealing, and not in the best interests of plan participants as required by ERISA. Recall that under ERISA, when acting as a fiduciary, there is a duty to act solely in the interest of plan participants and beneficiaries with the exclusive purpose of providing benefits and defraying reasonable plan expenses. This requires prioritizing participants' interests over the fiduciary's own interests or those of any third party.

There has been no argument that this practice was not permitted under IRS and Treasury regulations. While there has not yet been a full adjudication on the issues raised, the most compelling argument appears to be the discretion given by the plan document to the plan committee to make that decision. The question for the courts may well come down to a determination as to whether it was a settlor (as the fiduciary defendants have argued) or fiduciary decision. Recall that settlor decisions are those decisions made by the business owner for the business and are not required to be made in the best interest of participants.

Also Note

The Department of Labor has successfully filed suit against at least one employer that used forfeitures in a manner allowed by the law, but not permitted by the plan document.

Action Items for Plan Sponsors

1. Know what your plan document says about the use of forfeitures, and make sure that your approach is consistent with, and allowed by, the plan document.

2. If forfeitures are used to offset employer contributions, make sure that specific language is in the plan document, and that it is consistent with regulations. Consider changing language that provides discretion in applying forfeitures to language that specifically directs how they will be used. This may require a collaborative conversation with the service provider (e.g., recordkeeper or third-party administrator) that is providing the plan document.

3. As always, make sure you have a prudent process in place to review the plan investment menu and associated accounts (e.g., forfeiture account, revenue credit account, etc.) by having a retirement plan committee that is qualified and engaged, supported by experts.

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