Portfolio Media. Inc. | 230 Park Avenue, 7th Floor | New York, NY 10169 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Dueling Calif. Rulings Offer Insight On 401(k) Forfeiture Suits

By **Ashley Johnson and Jennafer Tryck** (July 17, 2024, 5:25 PM EDT)

Ashley Johnson

Jennafer Tryck

In the last couple of months, federal district courts have released the first two decisions addressing novel claims under the Employee Retirement Income Security Act challenging how 401(k) plan sponsors and fiduciaries use forfeited plan funds.[1]

Those decisions — Perez-Cruet v. Qualcomm Inc. in May and Hutchins v. HP Inc. in June — from the U.S. District Court for the Southern District of California and the U.S. District Court for the Northern District of California, respectively, reach opposite conclusions on the viability of the claims pled.

The decisions are at the forefront of a coming wave, with at least 11 new class actions filed in the last year making similar allegations.[2] As such, they provide early tea leaves for companies that may face such claims, providing reasons for both optimism and concern over the future direction of the law.

The forfeitures at issue in this new wave of lawsuits are of employer contributions to employee 401(k) accounts, such as matching contributions and annual profit-sharing contributions.

When a participant terminates employment before fully vesting in these contributions, the nonvested portion may become a forfeiture. That makes it important for any employer that does not have immediate vesting of these employer contributions to be aware of litigation concerning the use of forfeited funds.

The theory of the plaintiffs in recent forfeiture litigation, including the two recent California cases, is that these plan forfeitures should be used to pay plan administrative costs. Using them instead to offset company contributions, the plaintiffs allege, states a claim under ERISA.

This article provides background on plaintiff theories of liability, summarizes recent Internal Revenue Service guidance and court decisions in this space, and provides key takeaways for plan sponsors and fiduciaries evaluating how to use plan forfeitures.

Background on 401(k) Forfeiture Litigation

The use of forfeitures to offset employer contributions is a long-standing practice for many retirement plans. When an employee terminates his or her employment before fully vesting in an employer's contributions to a 401(k) account, the employee is not entitled to keep the unvested funds. Some employers elect to use these forfeited, unvested funds for contributions for current employees who are still enrolled in the plan.

The IRS has signaled that the tax code permits the use of forfeitures to reduce employer contributions, at least where the plan specifies that they may be used in this way.[3]

Indeed, the IRS has proposed to amend Treasury Regulation 1.401-7 to be crystal clear that employer contributions may be used "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."[4]

The issue in current litigation thus focuses not on the tax code, but on whether the use of a forfeiture to reduce employer contributions is consistent with ERISA. The plain text of ERISA does not expressly address the specific question of whether forfeitures can be used to pay company contributions where the plan provides for it.

The U.S. Department of Labor has also remained silent on this question, bringing suit only on a distinguishable fact pattern.

In particular, in 2017, the DOL sued a plan sponsor for using forfeited funds to reduce employer contributions — but only where doing so was, according to the DOL, contrary to the plan documents.[5] In Acosta v. Allen in the U.S. District Court for the Western District of Kentucky, the department alleged that the defendants' plans' governing documents required the defendants to use forfeited funds to pay plan expenses, such that the defendants' use of the funds to reduce employer contributions was improper.

According to the complaint, by failing to follow plan terms, the defendants breached their fiduciary duties under ERISA and engaged in prohibited transactions.[6] In September 2023, the court in Acosta entered a consent order and judgment that required the defendants to restore $575,000 to plan participants and pay $57,500 in penalties to the DOL.[7]

Perhaps emboldened by the Acosta litigation, plaintiffs began filing forfeiture lawsuits against 401(k) plan sponsors and fiduciaries.

In these suits, plaintiffs claim that the use of forfeitures to reduce company contribution costs breaches the fiduciary duties of loyalty and prudence, and violates ERISA's anti-inurement and prohibited transaction provisions. However, unlike in Acosta, these plaintiffs do not dispute that the defendants' plans expressly allow for forfeitures to be used to offset company contributions.

Yet despite the fact that the plans at issue may allow for this practice, plaintiffs contend that plan fiduciaries violate their ERISA duties of loyalty and prudence by applying forfeited funds to decrease future employer contributions instead of defraying administrative expenses that are otherwise paid by plan participants, and by failing to engage in a reasoned and impartial decision-making process when deciding to use forfeited funds in this way.[8]

In addition, under ERISA's anti-inurement provisions, plaintiffs assert that defendants' use of forfeitures to reduce future employer contributions saves employers from paying significant contribution costs, which causes plan assets to inure to defendants' benefit in violation of Title 29 of the U.S. Code, Section

1103(c)(1).[9]

Finally, plaintiffs contend that defendants violate ERISA's prohibited transaction provisions by utilizing forfeitures as a substitute for future employer contributions, which constitutes a direct or indirect exchange of plan assets for future contributions.[10] In the alternative, plaintiffs allege that defendants deal with plan assets, i.e., forfeitures, in their own interests instead of the interests of plan participants.[11]

Because these cases have largely been brought in the last nine months, they are still in the early stages**.** Only two courts — the Southern and Northern Districts of California in the present cases — have issued decisions on defendants' motions to dismiss — decisions that have adopted opposite views.

California District Courts Coming Down on Both Sides of the Issues

The Southern and Northern Districts of California have each recently weighed in on the merits of the theory that plan sponsors may not use forfeitures to offset company contributions. But despite substantially similar allegations, the courts reached opposite conclusions.

On May 24, the Southern District of California denied the defendants' motion to dismiss the plaintiff's complaint in Perez-Cruet v. Qualcomm Inc.,[12] allowing the plaintiff's claims to proceed to discovery. The defendants' plan allows for forfeitures to be used to reduce employer contributions or to pay administrative expenses.[13]

Nevertheless, the court first found that the plaintiff had stated a claim for breach of ERISA's duty of loyalty by alleging that the defendants put their own "interests above the interests of the [p]lan participants" when using forfeitures to offset future company contributions.[14]

The court also held that the plaintiff stated a claim for breach of the duty of prudence when it alleged that the defendants harmed participants by allowing them to pay higher administrative expenses in lieu of requiring the company to pay those costs.[15]

In permitting the plaintiff's anti-inurement claim to proceed, the court ruled that forfeited plan funds qualified as "assets of a pension plan" under ERISA Section 403(c)(1), and that the defendants' use of those funds benefited the company.[16]

Finally, the court found that the plaintiff had stated prohibited transaction claims, reasoning that forfeited funds constituted either "property" or "assets" of the plan under ERISA Section 406(a)(1), and that the defendants dealt with these assets for their "own interest" under Section 406(b).[17]

A few weeks later, on June 17, the Northern District of California **issued** a decision granting the defendants' motion to dismiss in Hutchins v. HP Inc.[18]

Just as in Perez-Cruet, the defendants' plan document allowed forfeited funds to be used to reduce employer contributions or pay plan expenses.[19]

While the court declined to give significant weight to the proposed IRS regulations that would allow the use of forfeited funds to reduce employer contributions, it nevertheless concluded that the plaintiff had failed to state a claim for fiduciary breach under ERISA because the defendants undisputedly complied with the plan's terms in their use of forfeitures.[20]

The court distinguished Perez-Cruet, concluding that the court's analysis in that case was "conclusory" and "d[id] not directly address many of the points" raised by the defendants in Hutchins.[21]

As the court explained, the plan did not require the defendants to use the forfeitures to pay administrative costs, and the plaintiff was not otherwise entitled to the payment of administrative costs under ERISA.[22] The court dismissed the anti-inurement claim because the plaintiff did not allege that the forfeited amounts were returned to the plan sponsor; they unquestionably "remain[ed] [p]lan assets" that defendants used to pay benefits to current and future plan participants.[23]

The court likewise concluded that the plaintiff's prohibited transaction claims must be dismissed because they fell outside of "the types of commercial transactions contemplated by Congress."[24]

Although the court held that the plaintiff's claims were implausible and must be dismissed, it granted the plaintiff the opportunity to replead.[25]

It remains to be seen whether the DOL or other courts will follow the lead of the Southern District of California in Perez-Cruet or the reasoning of the Northern District of California in Hutchins, or will tread an entirely new path on these novel issues.

The DOL has remained silent, neither issuing any guidance specifically directed at the plaintiffs' theories, nor filing an amicus brief in any of the 11 pending lawsuits mentioned above.

What's Next for Plan Sponsors and Fiduciaries

The plaintiffs' mixed record in the early cases may well be enough to suggest that plan sponsors and fiduciaries can expect to see more suits alleging ERISA claims related to the use of 401(k) plan forfeitures. Over the next year, the prognosis for these cases will no doubt become clearer; motions to dismiss are currently pending in four of the cases.

But in the meantime, and absent specific direction from the DOL, sponsors may want to consider reviewing their plan documents to assess whether their current practices for use of plan forfeitures comply with IRS guidance and the plan language itself.

Fiduciaries should also consider documenting their decision-making processes related to the use of plan forfeitures, demonstrating their adherence to the plan terms and any company policies regarding the use of forfeitures.

Ashley Johnson is a partner and Jennafer Tryck is a senior litigation associate at Gibson Dunn & Crutcher LLP.

[1] See Perez-Cruet v. Qualcomm Inc., No. 3:23-cv-1890 (S.D. Cal.), Dkt. 21 (Order on Mot. to Dismiss); Hutchins v. HP Inc., No. 5:23-cv-5875 (N.D. Cal.), Dkt. 53 (Order on Mot. to Dismiss).

[2] See, e.g., Madrigal v. Kaiser Fdn. Health Plan, Inc., No. 2:24-cv-5191 (C.D. Cal); Matula v. Wells Fargo & Co., No. 3:24-cv-3504 (N.D. Cal.); Prattico v. Mattel, Inc., No. 2:24-cv-2624 (C.D. Cal.); Nado v. John Muir Health, No. 3:24-cv-1632 (N.D. Cal.); Yagy v. Tetra Tech, Inc., No. 2:24-cv-1394 (C.D. Cal.); Barragan v. Honeywell Intl., Inc., No. 2:24-cv-1194 (C.D. Cal.); Hutchins v. HP Inc., No. 5:23-cv-5875 (N.D. Cal.); McManus v. Clorox Co., No. 4:23-cv-5325 (N.D. Cal.); Rodriguez v. Intuit, Inc., No. 5:23-cv-5053 (N.D. Cal.); Perez-Cruet v. Qualcomm Inc., No. 3:23-cv-1890 (S.D. Cal.); Dimou v. Thermo Fisher Sci. Inc., No. 3:23-cv-1732 (S.D. Cal.).

[3] See IRS, Internal Revenue Bulletin: 2023-11, IRS.GOV, available at https://www.irs.gov/irb/2023-11_IRB (last visited June 21, 2024); see also 26 CFR § 1.401-7; IRS Rev. Rul. 71-313 & 81-10.

[4] See Use of Forfeitures in Qualified Retirement Plans, 88 Fed. Reg. 12,282-01 (proposed Feb. 27, 2023).

[5] See Acosta v. Allen, et al., No. 3:17-cv-784 (W.D. Ky.), Dkt. 1 (Compl.).

[6] Id. at 6-7.

[7] News Brief, U.S. Dept. of Labor, Federal Court Orders Louisville Technology Services Provider, Retirement Savings Plan to Repay $575K to Plan Participants (Sept. 28, 2023), https://www.dol.gov/newsroom/releases/ebsa/ebsa20230928.

[8] Matula, No. 3:24-cv-3504, Dkt. 1 (Compl.) at 8.

[9] Id. at 9.

[10] Id. at 9-10.

[11] Id. at 10.

[12] No. 3:23-cv-1890, 2024 WL 2702207 (S.D. Cal. May 24, 2024).

[13] Id. at *1.

[14] Id. at *2.

[15] Id. at *3.

[16] Id. at *3-4.

[17] Id. at *5-6.

[18] No. 5:23-cv-5875, 2024 WL 3049456 (N.D. Cal. Jun. 17, 2024).

[19] Id. at *1.

[20] Id. at *3-4.

[21] Id. at *5, n.1.

[22] Id. at *6-7.

[23] Id. at *7-8.

[24] Id. at *9.

[25] Id. at *10.