VOL. 50, NO. 3 WINTER 2024

Employee Relations
LAW JOURNAL

ERISA Litigation

Conflicting Rulings in ERISA Cases Challenging Use of 401(k) Plan Forfeitures Create More Challenges for Plan Design and Administration

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As employee benefit plan sponsors know, navigating the regulatory requirements imposed by the Employee Retirement Income Security Act of 1974 (ERISA) can be challenging. Unfortunately, recent litigation challenges have created additional uncertainty. In the last year, courts have seen a number of new ERISA class actions in which plaintiffs have challenged 401(k) plan sponsors' use of forfeitures to offset employer matching contributions.

401(k) plans often include provisions that require a participant to work for the employer for a set period of time before their right to employer contributions to their account will vest. If the participant's employment terminates before contributions are vested, they forfeit the employer match. In a number of suits challenging these provisions, plaintiffs claim that it violates ERISA for the employer to use these forfeitures to defray the cost of the employer's future contributions to the plan. Instead, plaintiffs argue, employers should use these funds to offset the administrative expenses of the plan – which are otherwise charged to plan participants. These "forfeiture" cases represent a novel theory of liability against ERISA plan sponsors and present additional unchartered territory for both plan sponsors and the federal courts charged with resolving these disputes.

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In recent rulings, two district courts in California reached conflicting results on motions to dismiss the claims of plaintiffs pursuing ERISA claims challenging the reallocation of 401(k) plan forfeitures. The differences between the two opinions highlight that this is a developing area of litigation that plan sponsors should continue to monitor as these cases move through the courts.

PEREZ-CRUET V. QUALCOMM INC.

Perez-Cruet v. Qualcomm Inc.[1] was the first motion to dismiss ruling issued in any of the new forfeiture lawsuits. In *Perez-Cruet*, the plaintiff, a participant in his former employer's 401(k) plan, sued the employer and its benefits plan committee, claiming that the plan's use of forfeitures violates ERISA.[2] Under the terms of the plan, participants are immediately vested in their own contributions, but they are not fully invested in the employer's matching contributions until they have been employed with the company for more than two years.[3] The plaintiff claimed that the company's use of forfeited contributions to offset the cost of future contributions to the plan violated ERISA, and that instead, the employer should have used the funds to offset the administrative expenses of the plan.[4]

The defendants moved to dismiss, arguing that using forfeitures to defray future employer contributions is lawful under current Treasury Department regulations. The regulations provide that forfeited funds in qualified pension plans "must be used as soon as possible to reduce the employer's contributions,"[5] and the defendants argued that "qualified pension plans," as used in the regulation, include defined contribution plans like 401(k) plans because defined contribution plans are a type of pension plan under ERISA.[6] The defendants also pointed the court to a new proposed regulation that, if adopted, will expressly clarify that forfeitures may be used to offset employer contributions to a plan. The proposed regulation would clarify that forfeitures from a defined contribution plan may be used to "pay plan administrative expenses," "reduce employer contributions under the plan," or "increase benefits in other participants' accounts in accordance with plan terms."[7]

The court denied the defendants' motion to dismiss. The court deemed it significant that if the defendants had used forfeitures to offset the plan's administrative expenses in 2021, "all Plan participants would have benefited by incurring no administrative expense charge to their accounts" that year, which the court estimated would have saved plan participants $44 for the year.[8] Because, however, the plan sponsor had used the forfeitures to offset future contributions to the plan, the court concluded that the plaintiff had plausibly alleged that the defendants breached their fiduciary duties to plan participants by "making a choice that put the employer's interests above the interests of the Plan participants."[9]

The court similarly held that the plaintiff stated a claim for breach of ERISA's fiduciary duty of prudence because the defendants "allegedly harmed the participants by letting the administrative expense charge fall on [them] rather than the employer."[10] The court reached this conclusion despite the fact that the plan documents at issue expressly permitted the challenged use of forfeitures.[11] For similar reasons, the court also concluded that the plaintiff had stated claims for violations of ERISA's anti-inurement and prohibited transaction provisions.[12]

The court did not address the current Treasury Department regulation on which the defendants relied, but it noted that the proposed regulation was "not sufficient" to persuade the court because it had "not yet been adopted."[13] The court also noted that the regulation was proposed by the Treasury Department, rather than the Department of Labor, and thus found it had less "persuasive value."[14]

HUTCHINS V. HP INC.

Less than a month after the *Perez-Cruet* decision, another federal district court in California reached the opposite result in a very similar case – *Hutchins v. HP Inc.*[15] The *Hutchins* case involved the same claims and theories of liability that were presented in *Perez-Cruet*. The plaintiff, a participant in HP's 401(k) plan, sued the company and the plan committee, alleging that the defendants' use of forfeited employer matching contributions – which are not fully vested until after an employee has been with the company for more than three years – violates ERISA.[16] As in *Perez-Cruet*, the plaintiff asserted that forfeitures should have been used to offset administrative expenses of the plan, rather than to reduce the employer's future contributions.[17]

The defendants moved to dismiss. Although the court granted the motion, it rejected certain of the defendants' arguments, some of which were also addressed by the *Perez-Cruet* court. In particular, the defendants cited the same existing and proposed treasury regulations on which the *Perez-Cruet* defendants relied.[18] The court found that the existing regulation did not apply to the plan at issue because it is a stock bonus plan, and that the proposed regulation "does not foreclose Plaintiff's theory of liability because it is at best persuasive authority."[19] The court also noted that the proposed regulation would apply only to plan years beginning on or after January 1, 2024, which was outside the time period for which the plaintiff challenged the use of forfeitures.[20] The court also rejected the defendants' argument that they were acting in a settlor, rather than fiduciary, function in making the decision to allocate forfeited amounts.[21] The court reasoned that while the *decision* to include a term in the plan allowing forfeitures to be used to reduce employer contributions is a settlor function, the implementation of that decision is a fiduciary function because the defendants exercised discretion and control over plan assets – the forfeited funds.[22]

However, the court then went on to dismiss the plaintiff's claims for breach of the fiduciary duties of loyalty and prudence, concluding that the plaintiff's theory "has broad reach, and it is the theory's breadth that makes it implausible."[23] The court explained that if the plaintiff's theory is correct, "if given the option between using forfeited funds to pay administrative costs or to reduce employer contributions, a fiduciary is *always* required to choose to pay administrative costs."[24] This, the court found, is implausible. However, the court noted that the plaintiff "might be able to plausibly allege disloyalty or imprudence based on more particularized facts or special circumstances present in this case," and permitted the plaintiff to file an amended complaint.[25]

The court also rejected the plaintiff's claims for violations of ERISA's anti-inurement and prohibited transaction provisions. The plaintiff argued that using forfeitures to offset employer contributions was "akin to using plan assets to forgive an employer's debts," but the court disagreed, explaining that the forfeited employer matching contributions are never returned to the employer – instead, they are used to pay benefits to plan participants.[26] Again, however, the court granted leave to amend to "allege further facts showing that forfeited amounts were reverted or diverted to HP and/or that forfeited amounts were used to offset outstanding and unpaid obligations."[27] As to the prohibited transaction claim, the court agreed with the defendants that the payment of benefits is not a "transaction" in this context.[28] Nonetheless, the court also granted leave to amend as to that claim.

The *Hutchins* court specifically acknowledged its disagreement with the *Perez-Cruet* decision, noting that the ruling in *Perez-Cruet* was "conclusory" and failed to "directly address many of the points made by the defendants in the motion to dismiss."[29] Accordingly, the *Hutchins* court stated, it did not find *Perez-Cruet* persuasive in ruling on the motion to dismiss.

TAKEAWAYS FOR PLAN SPONSORS

Both the *Perez-Cruet* and *Hutchins* decisions acknowledge that these are novel theories of liability and that few courts have had occasion to weigh in on the viability of claims based on the reallocation of plan forfeitures. The conflict between these two rulings merely serves to highlight this fact. Although it is unclear to what extent the reasoning of either decision will be adopted in future cases, these lawsuits may fare poorly if other courts follow the court's reasoning in *Hutchins*.

Plan sponsors should consider what, if any, impact these rulings or similar potential challenges may have on their 410(k) plans. As with most ERISA claims, courts will first consider the language of the plan documents – including whether and to what extent the documents provide that forfeitures can be used to pay plan expenses or reduce employer contributions – in adjudicating further disputes over the use of forfeited employer contributions. Thus, plan sponsors should evaluate their plan language as compared to the language at issue in the above cases to assess how directly (or not) the outcomes in these cases might impact a challenge to their plan provisions.

Obviously, these decisions represent the initial results in what will likely be extended proceedings in these and other cases raising similar challenges. In the meantime, plan sponsors should monitor these and related challenges to plan procedures to evaluate the risk they may face of similar challenges.

Notes

1. No. 23-cv-1890 (S.D. Cal.).
2. 2024 WL 2702207, at *1 (S.D. Cal. May 24, 2024).
3. Id.
4. Id.
5. 26 C.F.R. § 1.401-7(a).
6. 29 U.S.C. § 1002(34).
7. 88 Fed. Reg. 12282, 12283, 12285 (Feb. 27, 2023).
8. 2024 WL 2702207, at *2.
9. Id.
10. Id. at *3.
11. Id.
12. Id. at *3-7.
13. Id. at *7.
14. Id.
15. No. 23-cv-5875 (N.D. Cal.).
16. 2024 WL 3049456, at *1-2.
17. Id. at *1.
18. Id. at *3.
19. Id. at *4.
20. Id.
21. Id. at *4-5.
22. Id. at *5.
23. Id. at *6.
24. Id.

25. Id. at *7.
26. Id. at *7-9.
27. Id. at *9.
28. Id. at *9-10.
29. Id. at *5 n.1.