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Novel 401(k) Plan Lawsuits Over the Use of Forfeitures

Swinging for the Fences or Plausible Claims?

by Kenneth F. Ginder on June 27, 2024

In our December 7, 2023 post, we noted five class action lawsuits, all filed by the same law firm within two months, in which 401(k) plan participants allege plan fiduciaries violated ERISA by using plan forfeitures to offset employer contributions instead of paying plan expenses. Recently, judges in two of the lawsuits came to different conclusions when ruling on motions to dismiss.[1]

On June 17, 2024, the U.S. District Court for the Northern District of California in Hutchins v. HP, Inc. issued an order *in favor of the employer and fiduciary committee* (hereinafter “HP”), dismissing the named participant’s claims against HP. As part of its order, the court granted the participant 30 days to amend his complaint to cure the issues identified by the court. In contrast, on May 24, 2024, the U.S. District Court for the Southern District of California in Perez-Cruet v. Qualcomm Incorporated issued an order *in favor of the named plan participant*, denying the employer’s and fiduciary committee’s (hereinafter “Qualcomm”) motion to dismiss.

This post summarizes the factual similarities in the two lawsuits, highlights and contrasts key aspects of each court’s claims analysis, and offers some commentary. It also provides steps for plan sponsors to consider taking in light of what may be a growing trend in ERISA litigation.

In both lawsuits, the plan document provides the plan administrator with discretion to use forfeitures to reduce employer contributions and/or reduce administrative expenses, and in operation forfeitures were consistently used to reduce employer contributions.

In each lawsuit the participant made the following claims: (1) breach of ERISA’s fiduciary duty of loyalty; (2) breach of ERISA’s fiduciary duty of prudence; (3) breach of ERISA’s anti-inurement rule; (4) prohibited transactions between the plan and a party in interest; (5) prohibited transactions by the fiduciary dealing with the assets of the plan in its own interest; and (6) failure to monitor fiduciaries.

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[1] A motion to dismiss is a request, typically by the defendant in the early stages of a lawsuit, to have all or part of the lawsuit dismissed by the court.

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In granting HP's motion to dismiss all six claims, the court stated that the lawsuit "presents a novel question: Whether and under what circumstances is a plan administrator's decision to use 'forfeited' employer contributions to a retirement plan to reduce employer contributions rather than to pay administrative costs a violation of [ERISA]?" It further observed that the participant "has opened with a swing for the fences—his Complaint takes the position that a failure to use forfeited contributions to pay administrative costs is always a violation of ERISA."

In denying Qualcomm's motion to dismiss, the court took a less skeptical view of the participant's claims, summarizing the participant's position as follows: "ERISA leaves only one choice: defray the administrative costs of the Plan." Noting that the legal standard for a motion to dismiss is whether the claim is "plausible," the court concluded that the participant had made plausible claims and the lawsuit could move forward.

The discussion of the six claims is more robust in the HP ruling than in the Qualcomm ruling. Highlights from rulings are contrasted below:

- *Fiduciary Breach Claims*

  HP Ruling: HP acted in compliance with the terms of the plan document and consistently with Treasury regulations. The participant's theory of liability has broad reach, and it is the theory's breadth "that makes it implausible." The effect of the participant's allegations is that if given a choice between using forfeitures to pay administrative costs or reducing employer contributions, a plan fiduciary is *always* required to choose to pay administrative costs. The flaw with the participant's theory is that it is not limited to any particular circumstances and is not context-specific, as required by the Supreme Court in the Dudenhoeffer decision. The participant's theory would require any fiduciary to use forfeited amounts to pay administrative costs regardless of context or circumstances. This "broad allegation is implausible."

  Qualcomm Ruling: Agreeing that fiduciary claims are context-specific, the court noted that if Qualcomm had used the $1.2M in forfeitures to pay the $954,000 in administrative expenses, all participants would have benefited by incurring no administrative expenses. The court ruled the participant had made a plausible claim that Qualcomm breached its fiduciary duty to participants by making a choice that put the employer's interests above the interests of the plan participants.

- *Inurement Claim*

  <u>HP</u> Ruling: The participant alleged that using forfeited amounts to reduce future employer contributions is akin to using plan assets to forgive an employer's debts, which violates ERISA's anti-inurement rule. The court noted that ERISA's anti-inurement rule provides that "assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purpose of providing benefits to participants in the plan and their beneficiaries and defray the reasonable expenses of administering the plan." However, the court explains that allegations of indirect or incidental benefits to an employer are not enough to cause a violation of the rule. When an employee terminates employment from before being fully vested in the employer match, the court explains, HP elected to use the forfeited amounts to supply 's matching contributions for other plan beneficiaries. This does not violate the anti-inurement rule because the forfeited amounts are plan assets that do not leave the plan trust fund and are used to pay plan benefits to participants. The fact that benefits through the reduction in its future matching contributions does not make the use of forfeited amounts in this way a violation of the anti-inurement rule—the benefit that receives is incidental to the payment of plan benefits. Accordingly, the court concludes that the participant's inurement claim is implausible.

  <u>Qualcomm</u> Ruling: As a threshold matter, the court questioned whether forfeitures are "plan assets," which is necessary for an inurement claim; however, it ultimately assumes they are and then focused its analysis on whether forfeitures can be considered mistaken contributions that are excepted from the anti-inurement rule. Ultimately, the Court concluded that the participant's claim is plausible and may move forward.

- *Prohibited Transaction Claims*

  <u>HP</u> Ruling: The payment of a benefit is not a "transaction" subject to the prohibited transaction rules. Forfeited amounts remain plan assets and are merely reallocated to provide benefits to other employees, which is not a prohibited transaction. Further, although reallocation of the forfeited amounts will reduce the amount that contributes as a match in the future, that does not make this a transaction for purposes of the prohibited transaction rules. The court found the prohibited transaction claims implausible.

  <u>Qualcomm</u> Ruling: The court noted that the proposed Treasury regulations allowing forfeitures to be used to reduce employer contributions are not yet adopted, do not have the force of law, and are not particularly persuasive (primarily because the Treasury—not the Department of Labor ("DOL")—proposed them and only the DOL has authority to define what constitutes plan

assets). The court concluded that the participant had made plausible prohibited transaction claims.

Although both lawsuits likely have a long way to go before concluding, the analysis by the court in granting HP's motion to dismiss is more sure-footed; for example, unlike the court's analysis in denying Qualcomm's motion to dismiss, it spends no time on whether a forfeiture is a plan asset or whether a forfeiture constitutes a mistaken contribution. In our view, the HP court concludes in a convincing manner that the participant has swung for the fences and missed, and its observation that the breadth of the participant's theory of liability extends beyond ERISA's bounds may well be prescient.

As we wait for the lawsuits to play out, plan sponsors should review the terms of their plans and ensure that the plans are being administered in accordance with their terms. To the extent a plan provides discretion, the decision on how forfeitures are used should be prudently documented. Plan sponsors should be circumspect about making wholesale changes to their plan documents based on a handful of lawsuits that are at the beginning of the litigation process. However, plan sponsors with plans that provide discretion may want to consider with their advisors whether to adopt a different plan design and eliminate discretion going forward to minimize the issues raised in these lawsuits. For example, plan sponsors may wish to consider with their advisors replacing discretion with an ordering rule (such as requiring that forfeitures first be used to reduce employer matching contributions and then used to pay administrative expenses).

If you have questions about using forfeitures within your retirement plan, please contact a member of Verrill's Employee Benefits & Executive Compensation Group.

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