Time to Re-think Use of Plan Forfeitures

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Over the past year, at least nine class actions under ERISA have challenged employers' use of forfeitures to reduce employer matching contributions. The first ruling in this wave of cases was issued on May 24, 2024, in *Perez-Cruet v. Qualcomm Inc.* The district court denied the employer's motion to dismiss, allowing the participants' claims to proceed.

Now, it is important to note that the court's holding is not a decision on the merits of the participants' claims, but rather a statement that the participants' claims at a minimum set forth a plausible set of facts which may entitle them to recover damages for losses to their individual accounts under the plan.

Background

The participants allege that the employer violated ERISA by choosing to use plan forfeitures to reduce its obligation to make matching contributions to participants' accounts rather than using the plan forfeitures to pay plan-related administrative expenses.

The plan's administrative expenses were paid through a direct charge to each participant's account on a quarterly basis. In 2021, for example, $1,222,072 of forfeitures were used to fund employer matching contributions for eligible participants. Under the terms of the plan, the employer had discretion and could have used the forfeitures to pay the 2021 plan administrative expenses of $954,269. The employer did not make that choice.

Dividing total administrative expenses among all participants suggests that a participant incurred an average administrative expense of $44 per year. Had the employer used the forfeitures to pay plan administrative expenses, participants would have benefited by incurring no administrative expense charge to their accounts.

The Qualcomm Plan provides: *Forfeitures shall be used at the discretion of the Company to reduce the Employer Contributions next payable under the Plan or applied to Plan administrative expenses.* (Emphasis added.)

While all agreed that the written terms of the plan allowed the employer to make either choice, the participants argue that overarching fiduciary principles under ERISA leave employers only one choice: Use forfeitures to pay the administrative costs of the plan.

ERISA Fiduciary Responsibilities

Section 404(a)(1) of ERISA imposes general duties on plan fiduciaries. One of the duties of a plan fiduciary is to "act 'solely in the interest of the participants' and for the 'exclusive purpose' of providing benefits to those participants."

In the matter at hand, the participants argue that Qualcomm breached this duty by choosing to use forfeited funds to reduce its own contributions to the plan rather than to pay the administrative expenses charged to participants. The participants argue 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.

Anti-inurement. ERISA Section 403(c)(1) states, "the assets of a pension plan shall never inure to the benefit of any employer and shall be held for the exclusive purposes of providing benefits to the participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan." The participants argue that Qualcomm violated this provision by utilizing forfeitures to offset the company's own contributions.

Prohibited transaction. The participants contend that the prohibited transaction provisions under ERISA 406(b) were violated when the employer used "plan assets" (in the form of forfeited funds) for future company contributions, thus violating the prohibition on dealing with plan assets for a fiduciary's own interest.

Very Troubling

The employer argued that they were following the written terms of the plan document, which, as noted above, reserved to the employer the discretion to use forfeitures to reduce the employer contributions or pay plan expenses.

In addition, the employer put a great deal of reliance on recent guidance from the IRS in the form a proposed regulation that forfeitures arising in any defined contribution plan (e.g., a 401(k) plan) may be used for one or more of the following 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.

The court reasoned that the general fiduciary duties under ERISA may in some cases trump the terms of the plan. The court stated that, "[Employer] may have complied with the Plan's terms which permit a choice. However, in this context, the [Employer's] choice allegedly harmed the participants by letting the administrative expense charge fall on the participants rather than the employer. Thus, by allegedly acting against the best interests of the Plan participants, Plaintiff has articulated a plausible claim of a breach of the duty of prudence by [Employer]."

Regarding the IRS proposed regulation, the court noted that the regulation has been proposed by the IRS rather than the Department of Labor ("DOL"). Thus, while the rule would certainly mean favorable tax treatment by the IRS of plan actions taken by the employer, ERISA's fiduciary responsibilities are administered by the DOL[1].

[1] The IRS opinion letter issued for pre-approved plan documents includes the following caveat: "Our opinion doesn't consider issues under Title I of the Employee Retirement Income Security Act (ERISA) which are administered by the Department of Labor.

And with respect to the prohibited transaction claims, the court held that, "by dealing with the nonvested contribution money in such a way that that it benefitted Qualcomm's own interest or for its own account, plaintiff plausibly alleges a completed prohibited deal under § 1106(b) . . . [assuming] nonvested money in a plan falls within the statutory language of "assets" of the plan."

Analysis

Using forfeitures to reduce employer contributions has been "standard operating procedure" for defined contribution and defined benefit plans for many years. But as is the case with many SOPs, these procedures should be reviewed now.

The first problem seems to be plan document language that purports to give the plan fiduciaries discretion to choose how to use forfeitures. Based on the court's reasoning in the Qualcomm decision, trial court's may be receptive to the argument that where plan fiduciaries are provided a choice between two competing interests, they will be required under ERISA to choose to use forfeitures to pay plan expenses. In other words, employers may breach their fiduciary duties to participants by making a choice that puts the employer's interests above the interests of plan participants.

Faced with this predicament, what pro-active steps should employers consider taking now?

Settlor Functions

The DOL has taken the position that there is a class of activities which relates to the formation, rather than the management, of plans. These activities, referred to as "settlor functions," include decisions relating to the formation, design and termination of plans, and are not activities subject to the fiduciary duties under Title I of ERISA.

If the employer intends to use forfeitures to reduce employer contributions, then hard wire that procedure into the plan documents by providing that "forfeitures shall be used to reduce the employer contributions" rather than "may be used."

Take action to frame the decision regarding how to use forfeitures, as being a settlor decision by the employer rather than a fiduciary decision by the plan administrator. This action could take the form of a resolution by the employer's board of directors or a directive from an authorized officer of the employer to the plan administrator[2].

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[2] As an aside, it is worth noting that this is one reason among many that in drafting plan documents, do not simply check the box that names the employer as the plan administrator. Rather, designate the Plan Committee as the plan administrator. Avoid later confusion where the employer acts regarding the plan – was the employer acting in its capacity as the employer (generally subject to the "business judgment rule") or as the plan administrator (subject to ERISA's fiduciary requirements)?

The employer can now argue that the plan administrator is no longer exercising discretion, i.e., is no longer making a choice that puts the employer's interests above the interests of the plan participants.

Or consider amending the plan documents to require that "forfeitures shall be used to reduce the employer contributions" rather than "may be used."

There is one question that should be considered regarding amending the Plan. Most employers use an IRS "pre-approved" plan document. The IRS provides that, "An Adopting Employer may rely on an Opinion Letter issued with respect to a Pre-approved Plan only if the employer's plan is identical to the Pre-approved Plan. *An employer that amends any provision of a Pre-approved Plan, including its adoption agreement, . . . will lose reliance on the Opinion Letter.*"

Here, the Adoption Agreement may be helpful if the Adoption Agreement allows the employer to adopt an Addendum to set forth use of forfeitures. This type of "fill-in-the-blank" provision would not be considered to be a plan amendment.

Also, the IRS has further provided that, "The following types of amendments will not cause a plan to fail to be identical to a Pre-approved Plan and, thus, will not result in the employer losing reliance on the Opinion Letter: "Amendments to the administrative provisions in the plan (such as provisions relating to investments, plan claims procedures, and employer contact information), provided the amended provisions are not in conflict with any other provision of the plan and do not cause the plan to fail to qualify under § 401".

The amendment would likely be considered an administrative provision that will not result in the employer losing reliance on the Opinion Letter.

Plan assets. What to do about ERISA's anti-inurement and prohibited transaction provisions?

Here, dicta from the *Qualcomm* court may be helpful. The court noted that "ERISA does not define "assets."" ERISA provides that "the term 'plan assets' means plan assets as defined by such regulations as the Secretary may describe" and "Unfortunately, the Secretary of Labor has not defined plan assets in terms of employer contributions -- whether vested or nonvested."

The court reasoned that, "To avoid ambiguity, Qualcomm as settlor of its employee pension plan could have defined "assets of the plan," for purposes of its plan, as excluding nonvested employer . . . contributions."

So, I suggest that employers do just that, i.e., acting in the employer's capacity as the settlor, define plan assets as excluding nonvested employer contributions.

Conclusion

The court's decision in the *Qualcomm* case to deny the defendant's motion for summary judgment informs employers, at a minimum, that what has up until now been standard operating procedure for deciding how to use forfeitures needs to be reconsidered.

If an employer intends to use forfeitures to offset employer contributions that the employer is otherwise obligated to make under the terms of the plan document, then the employer should consider: (1) making this a settlor decision and over-ride troublesome language in the plan document that reserves discretion to plan fiduciaries to use forfeitures to pay plan expenses, and (2) taking action to define plan assets to exclude nonvested employer contributions.

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