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A CHUBB SPECIAL REPORT:

A Primer on 401(k) Forfeiture Litigation

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Over the past year, the ERISA plaintiffs' bar has filed a new wave of class-action lawsuits alleging a novel theory about the use of 401(k) plan forfeitures — i.e., employer contributions that participants forfeit when they leave the plan before those contributions vest. Consistent with decades of regulatory guidance, it has long been the practice for defined-contribution plans to provide that forfeitures can be used to reduce or offset employer contributions, pay plan expenses, and/or otherwise be allocated to participants.

In these new lawsuits, plaintiffs allege that using forfeitures to offset employer contributions violates ERISA's duties of prudence and loyalty, as well as ERISA's anti-inurement provision. Plaintiffs also claim this practice constitutes a prohibited transaction under ERISA. Under plaintiffs' theory, the only permissible choice is for the employer to use forfeitures to pay plan administrative expenses.

These cases are still in their infancy, and to date the courts' reactions to plaintiffs' theories have been mixed. Considering the increasing number of forfeiture lawsuits and the uncertain future they face, plan sponsors and fiduciaries may find it helpful to have some background on the historical treatment of forfeitures, the lawsuits, the defenses asserted, and issues to watch going forward.

Primer on Defined-Contribution Plan Forfeitures and Regulatory Background

Under ERISA, participants in defined-contribution plans are always fully vested in their own contributions. However, employers are allowed to create vesting schedules for employer contributions, and ERISA requires that all employer contributions must vest within six years of service. Forfeitures generally occur when participants leave the plan before they are fully vested in the employer contributions made on their behalf. Forfeitures can amount to millions of dollars per year for larger employers.

In regulations dating back to 1963 (before ERISA was enacted), the Internal Revenue Service ("IRS") has addressed how ERISA-covered pension plans (which include defined-contribution plans) may handle forfeitures, stating that such amounts "must be used as soon as possible to reduce the employer's contributions under the plan." In 2023, the IRS issued a proposed regulation that would make clear that forfeitures in defined-contribution plans may be used to offset employer contributions, pay reasonable plan administrative expenses, and/or otherwise be allocated to participants, by no later than the end of the year following the year of forfeiture. During the 60 years between these two regulatory actions, both the Treasury Department and Congress have indicated that using forfeitures to offset future employer contributions is lawful.

ERISA itself is silent regarding the permitted use of forfeitures. The entity with primary enforcement power over ERISA, the Department of Labor ("DOL"), has never asserted that using forfeitures to offset future employer contributions violates ERISA. To the limited extent this issue has previously arisen in litigation, the DOL has focused on whether fiduciaries are complying with the written plan terms regarding the allocation of forfeitures.

The New Wave of Claims: Forfeiture Class Actions

The recent class actions allege that using forfeitures to offset employer contributions, rather than pay plan expenses, violates several ERISA provisions. Importantly, these lawsuits do not allege that participants received anything less than the full employer contributions the plan promised them. Instead, the general theory is that reallocating forfeitures to provide employer contributions to other participants under the plan — which in turn reduces the future contributions the employer must make—prioritizes the employer's financial interests over the best interests of plan participants. That is, using forfeitures to offset the employer's contributions decreases the "new" contributions the employer needs to make in the future, rather than using these forfeitures to offset administrative costs that reduce the value of participants' accounts.

Specifically, the lawsuits allege that using forfeitures to offset an employer's future contributions instead of paying administrative expenses violates ERISA in the following ways:

1. **Breach of the Duty of Loyalty.** ERISA's duty of loyalty requires a fiduciary to act "solely" in participants' interests and for the "exclusive purpose" of either paying plan benefits or defraying plan costs. Plaintiffs' theory is that using forfeitures to offset an employer's future contributions *only* benefits the employer, by decreasing the amount of contributions it needs to make in the future. Plaintiffs therefore claim that a fiduciary acts disloyally and not "solely" in participants' interest by declining to use forfeitures to pay plan costs instead, which may otherwise be charged to participants' accounts.
2. **Breach of the Duty of Prudence.** ERISA's duty of prudence generally requires that a fiduciary act reasonably, as measured against other prudent fiduciaries in similar circumstances. Plaintiffs thus contend that fiduciaries must engage in a reasoned and impartial process for deciding how to use forfeitures. Plaintiffs assume that prudent fiduciaries following such a process would use forfeitures to pay plan expenses, based in part on their theory that using forfeitures to offset future employer contributions is not in plan participants' best interest.
3. **Prohibited Transactions.** ERISA's prohibited transaction provisions, as the name implies, prohibit certain transactions between certain parties. Plaintiffs allege that using forfeitures to offset employer contributions is a "transaction" — i.e., an exchange of assets between the plan sponsor and the plan. As with their loyalty claim, Plaintiffs allege that using forfeitures to offset contributions amounts to "self-dealing," because it reduces the amount of contributions an employer has to make to the plan.
4. **Anti-Inurement Violation.** ERISA's anti-inurement provision mandates that assets of a plan shall never inure to the employer's benefit, but rather must be held for the exclusive purposes of providing benefits to participants and defraying reasonable plan expenses. Plaintiffs claim that using forfeitures to offset future employer contributions causes plan assets to "inure" to the benefit of the employer, not participants, because it reduces the amount the employer will have to contribute to the plan for a given time period.

Primary Defenses Asserted in the Lawsuits

Defendants have sought to dismiss these allegations based on several defenses, some of which are summarized here:

1. **ERISA Does Not Entitle Plaintiffs to a Greater Benefit Than the Plan Provides.** ERISA does not mandate that plan sponsors offer any particular benefits (or any benefits at all). Rather, ERISA only protects the benefits promised to participants under the terms of the plan. ERISA does not require that employers pay the costs of administering the plans they offer, and it is common for those costs to be charged to plan participants. Defendants have argued that accepting plaintiffs' theory would mean ERISA effectively creates a new substantive benefit—free administrative services — which is inconsistent with the statute's purpose and language.

2. **Decades of Settled Law Foreclose Plaintiffs' Claims.** Defendants have argued that current and proposed IRS regulations explicitly permit the use of forfeitures to offset employer contributions if the plan allows it. At a minimum, Defendants argue that since the IRS has a prominent role in regulating 401(k) plans — and that tax qualification of such plans is a primary incentive for employers to establish them in the first place — it is implausible that the IRS would allow conduct that Plaintiffs allege violates ERISA.

3. **Plan-Design or "Settlor" Decisions.** Decisions regarding plan funding and how to pay plan administrative expenses are matters of plan design. Plan design decisions are not subject to ERISA's fiduciary rules, meaning a sponsor can structure its plan however it chooses (within the outer bounds of ERISA). Defendants have argued that plaintiffs' claims are not viable because they ultimately challenge plan design decisions, including by dictating how much the sponsor will contribute and effectively forcing the employer to pay for all or most plan administrative costs.

4. **Compliance with Plan Language.** Many defined-contribution plans contain provisions that specifically authorize the use of forfeitures for certain purposes, including to offset employer contributions. Since ERISA requires that fiduciaries follow the plan's terms (so long as the terms do not violate ERISA), Defendants have argued that there is no breach of duty because the fiduciaries are acting consistently with the plan's lawful terms regarding the use of forfeitures.

5. **Forfeitures Are Still Being Used to Pay Participant Benefits.** Defendants have also noted that the forfeitures in these cases do not revert to the plan sponsor. They remain in the plan trust and are used to pay benefits called for by the plan for other participants, which is consistent with ERISA's loyalty and anti-inurement provisions. Both parts of ERISA require that plan assets be used for the "exclusive purpose" of providing benefits to participants, which is exactly how forfeitures are used. Far from self-interested conduct, Defendants argue, the plans are simply reallocating employer contributions from participants who did not vest to other participants who receive an employer contribution.

The Uncertain Legal Landscape

These cases are still in the early stages. Some courts have dismissed Plaintiffs' lawsuits as contrary to ERISA's rules and the decades of regulatory guidance regarding the use of forfeitures, while others have found the same claims to be plausible and have allowed the cases to move forward.

The language of the plan documents has been an important variable in these cases. Plaintiffs have argued — and some courts have agreed — that when the plan document gives a fiduciary discretion over whether to use forfeitures to pay administrative costs or offset future employer contributions, this implicates fiduciary conduct. Further, one court allowed a case to proceed because plaintiffs alleged that the plan fiduciaries' handling of forfeitures did not comply with the plan's forfeiture provisions.

Courts that have rejected plaintiffs' theories have also looked to the terms of the plan in finding that nothing in the plan promises participants the additional benefit of employer-subsidized administrative services. Also one court dismissed the claims where the plan document *required* that forfeitures be used to offset employer contributions. Numerous motions to dismiss remain pending and it is hard to predict whether they will succeed, considering the mixed results so far.

The Future of Forfeitures and Considerations for Plan Sponsors and Fiduciaries

Looking forward, there is a very real possibility that plaintiffs' firms will continue to bring these claims, regardless of their merit. If plaintiffs are successful in surviving motions to dismiss, we can expect to see even more of these cases (or to see similar forfeiture claims tacked on to other common claims asserted in ERISA class-action litigation).

While the future of these cases is uncertain, many plan sponsors are evaluating how their plan documents address employer contributions, administrative expenses, and the use of forfeitures. There is no one-size-fits-all approach. However, now would be a good time to review plan documents to ensure, at a minimum, that the use of plan forfeitures is consistent with plan terms.

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