

# Defined Contribution Plan Forfeitures: Proposed Regulations and Recent Litigation

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April 25, 2024

There have been recent developments from both the Internal Revenue Service (“IRS”) and the Department of Labor (“DOL”) and pending court cases about how plan forfeitures under defined contribution retirement plans must be handled. As described in more detail below, however, there are inconsistencies among these developments that plan sponsors need to be aware of. The purpose of this advisory is to summarize what the potential conflicts are and to make sure that employers are aware of them, and that until these potential conflicts are resolved, employers are administering their plans so as not to violate any of the rules.

## *IRS Proposed Regulations*

The IRS issued proposed regulations in February 2023 providing guidance as to when and how plan forfeitures under defined contribution plans<sup>[1]</sup> can be used. Under the proposed regulations, forfeitures may be used for one or more of the following purposes: (i) to pay plan administrative expenses, (ii) to reduce employer contributions under the plan, or (iii) to increase benefits in other participants’ accounts in accordance with plan terms. With respect to when the forfeitures must be allocated, the rules provide that the deadline is 12 months after the close of the plan year in which they were incurred, so forfeitures incurred in 2024 will be required to be used by December 31, 2025. In addition, with respect to any forfeitures incurred prior to 2024, the rules provide for the same deadline as forfeitures incurred during 2024 (i.e., they must be used by December 31, 2025).

## *Department of Labor Guidance and Pending Court Cases*

On a related note, there have also been several DOL and case law developments that raise additional questions about how an ERISA plan should use plan forfeitures. On September 28, 2023, the DOL published a news release announcing an order requiring Sypris Solutions Inc. to restore \$575,000 to its 401(k) plan participants due to the company’s use of forfeitures to reduce employer contributions. While Sypris’ plan document specifically required that forfeitures be used to pay plan expenses, the DOL’s reasoning for the \$575,000 judgment appears to be not only that Sypris failed to follow the terms of its plan document, but also that it benefited “at the expense of plan participants.”

Shortly after the DOL’s news release, a plaintiffs’ law firm, Hayes Pawlenko LLP, filed class action lawsuits in California’s district courts against eight companies<sup>[2]</sup> alleging that the companies improperly handled forfeitures in their 401(k) plans by using them to reduce employer contributions. <sup>[3]</sup> The plaintiffs claim that by doing so, the companies chose to save themselves millions of dollars

each year instead of reducing the amounts charged to participants' individual accounts for administrative expenses, thereby violating their fiduciary duty to act "solely in the interest of the participants and beneficiaries" and "for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan." The complaints also claim that the companies' use of forfeitures constituted a prohibited transaction because it benefited the companies, which were parties-in-interest.[4]

It is important to note that the plans at issue in the majority of the class action lawsuits complied with the proposed IRS regulations because they permitted the use of forfeitures for either paying plan expenses or reducing employer contributions.[5] As such, the plans did not violate any tax rules, but could be found to be noncompliant with the DOL's reasoning in its Sypris order that the use of forfeitures cannot benefit the company at the expense of participants and beneficiaries.

### Summary

In light of the proposed IRS regulations and the somewhat unclear DOL order against Sypris, and the pending lawsuits, we strongly recommend that plan sponsors at a minimum continue to follow the IRS regulations and ensure that their plans are operated in accordance with their plan documents. Employers should also be aware that there still remains the issue of whether there is a potential DOL violation for using forfeitures to reduce employer contributions instead of paying plan expenses, even though doing so is expressly permitted by the IRS and is a common practice under defined contribution plans. We will monitor developments in this area. In the meantime, we urge you to contact one of the attorneys in the Kelley Drye Employee Benefits Department to discuss whether the existing language in your plan document, as well as your administrative practices, should be reviewed in light of the changing landscape regarding use of forfeitures.

[1] The proposed regulations also remove the requirement that forfeitures under defined benefit plans be used as soon as possible to reduce employer contributions. For purposes of this advisory, we will focus on the impact of the new requirements on defined contribution plans.

[2] The defendant companies are Thermo Fisher, Intuit, Qualcomm, Clorox, HP, Honeywell, Tetra Tech, and Mattel.

[3] Another plaintiffs' law firm, Walcheske & Luzi LLC, has recently added a similar forfeiture claim to its broader 401(k) mismanagement lawsuit against John Muir Health, a hospital network.

[4] The defendant companies, in turn, have filed motions to dismiss, arguing in part that deciding what benefits to provide and how to fund them is a settlor function, and therefore they were not ERISA fiduciaries with respect to the use of forfeitures.

[5] Also, since the plans in these lawsuits did not require that forfeitures be used exclusively to pay plan expenses, these plans are technically distinguishable from the Sypris plan.