LEGAL UPDATE

Longstanding Internal Revenue Service Position on Forfeitures Called Into Question

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Recently, several class action lawsuits have been filed challenging the permissibility of plan language providing discretion as to how forfeitures should be used. These suits allege that the plan fiduciaries violated their duties of prudence and loyalty under Title I of ERISA by applying forfeitures to reduce employer contributions instead of applying forfeitures to reduce administrative expenses borne by plan participants. The complaints also allege that applying forfeitures to reduce employer contributions violates ERISA's anti-inurement provisions and constitutes a prohibited transaction under ERISA Section 406(a) and 406(b).

Forfeitures arise when participants terminate employment without being fully vested in some or all of the employer contributions allocated to their accounts. The Internal Revenue Service's (IRS's) longstanding position has been that forfeitures in a tax-qualified defined contribution plan can be used in only three ways: (a) payment of reasonable plan expenses; (b) reduction of employer contributions; or (c) allocation to plan participants. There are a variety of ways in which relevant plan language can reflect this IRS position.

For example, a plan could be drafted in the passive voice to simply say that forfeitures can be used only for those purposes. Alternatively, plan language could state that the relevant plan fiduciary has discretion with respect to the use of forfeitures. Or the plan could specify the order in which forfeitures will be applied, for example, first to reduce future employer contributions and then to pay reasonable plan expenses. One reason that this latter approach is often used is because it removes discretion and therefore the application of the rule is not a fiduciary function.

However, if using forfeitures to reduce employer contributions benefits a plan sponsor in violation of Title I of ERISA - as discussed more fully below - it could be argued that removing discretion does not preclude a finding of breach of fiduciary duty by the plan fiduciaries applying the ordering rule. This conclusion could depend on whether the sponsor's obligation is viewed as contingent and therefore never arising, or whether the obligation did arise but was extinguished.

The DOL has not issued specific guidance addressing the IRS's position on the permissible uses of forfeitures. While this could be seen as acquiescence in the IRS position, such an argument would be undercut by the authority noted below. To provide a frame of reference, there are occasions in which the IRS and the DOL have differing views on how the Code and ERISA apply to specific circumstances, such as escheatment of plan assets and, prior to the SECURE Act, multiple employer plans.

If exercising discretion to reduce employer contributions violates ERISA's anti-inurement rules and/or constitutes a prohibited transaction by using plan assets for the benefit of a party in interest, then plan language permitting the relevant fiduciary to exercise discretion in that manner should not have been included in the plan document in the first instance. Viewing the cases from that perspective, the issue is one of a flawed plan document, which results in a breach of fiduciary duty under Title I of ERISA, because the challenged exercise of discretion should not have been a part of the plan. To provide further context, the IRS consistently notifies the public that its approval of a plan is solely for Title II, *i.e.*, Internal Revenue Code, purposes and does not address Title I issues.

Such limitation substantially undercuts the use of the long-standing IRS position on the use of forfeitures as an ERISA defense for plan fiduciaries accused of abusing discretion.

While many comments to date on these lawsuits assume they are unlikely to succeed, we cannot predict how these particular challenges to a plan's forfeiture policy will be resolved. We believe that properly drafted plan documents are likely to have a stronger defense against these lawsuits. Nonetheless, there is authority that could support plaintiffs.

For example, in DOL Field Assistance Bulletin 2008-01, the DOL, citing Bogert in The Law of Trusts and Trustees, stated that where a trustee retains possession of trust assets, "the trustee must hold the settlor to [this] obligation." Similarly, the United States Supreme Court has stated that the collection of contributions is a trustee's responsibility under ERISA. Plan fiduciaries with discretion as to how to apply forfeitures could be argued not to be the type of fiduciary to whom the responsibility of collecting contributions was directed, but there is no certainty that a District Court would view such an argument favorably to the fiduciaries.

Pending resolution of one or more of these cases, it is appropriate for plan sponsors now to review the forfeiture provisions of their defined contribution plans to determine what, if any, actions might be advisable. For example, if fiduciaries are given discretion as to how forfeitures should be allocated, consideration should be given to providing some objective process mandating the basis on which such decisions are made. In addition, consideration should be given to whether fiduciary decisions could be seen as relieving the employer of an obligation to the plan.

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