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DOL vs. IRS rules: Courts asked to decide how 401(k) plans can use forfeiture assets

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VIEW KEY DATA:

Nordstrom Inc.

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What started as a small law firm filing a handful of suits against 401(k) plans' use of forfeited funds has metastasized into a broad attack on sponsors that raises questions about reducing participants' expenses.

It's a trend of more law firms filing more lawsuits seeking to use Department of Labor regulations regarding fiduciary duty to supersede IRS rules.

Although there are differences among the various sponsor-defendants, the general theme is the same: What can sponsors do with company contributions to a participant's retirement account if the employee leaves before being fully vested? (Participants' contribution aren't affected.)

Plaintiffs want this forfeited money to be used to reduce plan expenses, which in turn reduces participants' expenses. However, some plans use the forfeited funds to reduce employers' contributions to the plans.

The IRS says defined contribution plans can use the forfeiture money to reduce employer contributions to the plan or to reduce plan expenses.

ERISA's duty of loyalty guidelines say sponsors must place participants' interests ahead of corporate ones. Plaintiffs' attorneys argue that ERISA supersedes the IRS.

The eruption of lawsuits has been accompanied in the early stages by divergent federal court decisions that don't give plan sponsors — and their ERISA attorneys — a clear picture about how to defend against the lawsuits.

"It's regulation by litigation," said Daniel Aronowitz, president of Encore Fiduciary, a fiduciary liability insurance underwriting company. "Plaintiffs' lawyers are the ERISA police. It's unfair."

In 12 months of lawsuits, the list of defendants includes a who's who of the largest corporate retirement plans as well as smaller 401(k) plans.

Initial defendants were Clorox, Intuit, Thermo Fisher Scientific and Qualcomm, all sued between mid-September and mid-October 2023. Then came HP Inc. in November.

Honeywell International and Tetra Tech were sued in February; followed by John Muir Health, a hospital system, in March; Mattel in April; and Wells Fargo in June.

Recent lawsuits, all in August, included Home Depot, Bank of America, **Siemens Corp.**, **Nordstrom Inc.**, Smith & Nephew and LifePoint Health. In September, it was Novo Nordisk, the Danish maker of Ozempic, and Knight-Swift Transport Holdings.

"The plaintiffs' bar has an eye out for opportunities," said Nevin Adams, an attorney and former chief content officer for the American Retirement Association. "We'll have federal judges coming out with different decisions. It will be a mess for awhile."

Court rulings

Among six federal court rulings so far, judges have rejected petitions by Qualcomm and Intuit to dismiss complaints. Judges have dismissed lawsuits against HP (plaintiffs have appealed), Thermo Fisher Scientific and BAE Systems. A sixth judge ruled that the complaint against Tetra Tech should be resolved via arbitration.

The early lawsuits and many of the new ones focused solely on the 401(k) plans' forfeiture practices. However, some plaintiffs who initially sued sponsors over fees or investment choices amended their complaints to include challenges to forfeiture policies.

One example is Middleton vs. Amentum Government Services Parent Holding, in which a 401(k) plan participant sued in October 2023 alleging excessive investment fees and poor investment choices. In August, a federal magistrate judge for the U.S. District Court in Wichita, Kan., granted the plaintiff's third amended complaint to include challenges to the 401(k) plan's forfeiture policy.

DOL rules

Some new lawsuits have packaged a forfeiture complaint among other accusations of ERISA violations.

The John Muir Health lawsuit, by a 401(k) plan participant, and the Novo Nordisk lawsuit, by

former employees, both combined forfeiture allegations amid claims of high record-keeping fees and poor investment choices as ERISA violations.

Unlike lawsuits in which plaintiffs' lawyers conduct extensive research comparing a defendant's record-keeping fees, investment management fees or investments' performance against other retirement plans, forfeiture cases require relatively less homework.

"Forfeiture cases are very straightforward at this point because we know where the money has gone," said Michael Schloss, of counsel to the Wagner Law Group.

"The numbers are easy to find," Adams added. "These are big numbers. It's a fairly easy argument to make" about forfeited funds that plaintiffs say should be used to reduce plan expenses.

Forfeiture claims are affected by multiple factors: a sponsor's retirement plan document, the number of participants, the vesting policy for employer contributions and the years plaintiffs allege ERISA violations took place.

In the Qualcomm case, for example, plaintiffs allege that between 2019 and 2021 the sponsor should have reduced plan expenses by \$3.4 million instead of using the forfeited funds to reduce company contributions. Participants are vested 50% for employer contributions after their first year and 100% after their second year.

In the Intuit case, plaintiffs allege that between 2018 and 2021 the sponsor should have reduced plan expenses by \$15.2 million instead of reducing company contributions. For the Intuit plan, the vesting period for employer contributions takes place "over a period of years depending on when the participant was hired."

Plan documents for Qualcomm and Intuit give sponsors a choice of using forfeited funds to reduce plan expenses or to reduce employer contributions.

Need assist from DOL

The problem for sponsors is compounded by a lack of reconciliation between the IRS and the DOL, whose ERISA guidelines define a sponsor's fiduciary duty.

"It would be nice" if the DOL and IRS would act to reduce the uncertainty, said Wagner Law Group's Schloss. "A government announcement one way or the other would go a long way to resolving the issue."

ERISA experts said they aren't aware of any recent DOL efforts, such as filing an amicus brief in a forfeiture case, to articulate policy.

"We need the Department of Labor to step in and give guidance," Aronowitz said. "The sponsors are making a good faith effort to follow the IRS regulations."

DOL did file a complaint in December 2017 against Sypris Solutions and its retirement plan fiduciaries, saying they violated the terms of the plan document, which said forfeited funds must first be used to reduce plan expenses before reducing employer contributions.

The parties fought each other in court for six years before finally reaching a settlement of \$575,000 to pay participants, plus an ERISA fine of \$57,500.

One key issue in the legal debate is whether a forfeited amount is deemed a plan asset. If so, then a sponsor's action on forfeitures is a fiduciary event and subject to ERISA's rule on duty of loyalty.

If managing forfeitures is considered an administrative role under ERISA — such as creating, designing or terminating a plan — this is not a fiduciary one.

If courts focus on forfeitures as plan assets, "there will be teeth to these lawsuits," said Schloss. "I expect there will be more cases."

Another key issue is how a sponsor's plan document is written.

One way to avoid a lawsuit is to have a plan document that only allows forfeited funds to reduce plan expenses, lawyers say.

Another recommendation is to write a plan document that says forfeited funds can only be used to reduce employer contributions.

Writing a plan document that only addresses employer contributions "would certainly take the wind out of the sails of plaintiffs' lawsuits," said Schloss.

"Amend the plan document to take the choice out of an administrator's hands" by removing fiduciary responsibility, Caleb Barron, a partner in the law firm of Bradley Arant Boult Cummings, said in an interview. "In that way, the administrator is just following the document."

Given the flurry of lawsuits, DC plans that give plan executives discretion in using forfeited funds “may be the low-hanging fruit” for ERISA complaints, he said.

“Generally, if a plan administrator is acting with discretion, it is acting in a fiduciary capacity” and subject to an ERISA claim, Barron wrote in a note to clients.

“When the plan administrator has no discretion, it is generally acting in a ministerial capacity,” the note said. “The key is that the plan administrator cannot be faulted for making a choice it does not have.”

However, some plan documents may lend themselves to interpretations upon which plaintiffs’ lawyers seize to claim sponsors should have cut plan expenses.

One such example is Sievert et al. v. Knight-Swift Transportation Holdings Inc., filed Sept. 16 in a U.S. District Court in Phoenix, by current and former employees of the company’s 401(k) plan. The sponsor ignored its plan document, plaintiffs alleged.

“The plan document, which describes the plan’s terms and conditions related to the operation and administration of the plan provides defendant must first use forfeitures to pay plan expenses,” the lawsuit said.

“Defendant violated the terms of the plan document by using forfeitures first for its own benefit and not for the benefit of the plan,” the lawsuit said. “There was no discretion, process, consideration of using forfeited funds for anything other than to benefit defendant.”

The sponsor should have used \$4.6 million in forfeited funds from 2017 through 2022 for reducing plan expenses, the lawsuit said.