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ANOTHER LOOK AT 401(K) PLAN INVESTMENTS IN EMPLOYER SECURITIES

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In 1998, I published an article in the Yale Journal on Regulation entitled, *Pension Plan Investments In Employer Securities: More Is Not Always Better*.[1] I argued in that article for more regulation of investments in employer securities by pension plans, particularly 401(k) plans, on the grounds that significant accumulations of employer stock by pension plans leads to insufficient diversification of employee's retirement portfolios. I also argued that an excessive accumulation of employer securities insulates managers from hostile takeovers and shareholder proposals.[2] The article was published during a sustained period of rising stock values[3] and it received little attention. It was not until the fall of Enron, and reports of the staggering losses to Enron employee 401(k) plan account balances,[4] that I started receiving phone calls and e-mails from Senate staffers, reporters, and even 401(k) plan administrators telling me how interesting they found the article.

A lot has happened since 1998, but nothing has changed my conviction that more regulation of 401(k) plan investments in employer securities is warranted, and that such regulation must involve more than disclosure and education. This Article explores

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1. Susan J. Stabile, *Pension Plan Investments in Employer Securities: More is Not Always Better*, 15 YALE J. ON REG. 62 (1998).

2. *Id.* at 90-106.

3. *See* Patrick McGeehan, *Wall St. Isn't Expecting Much Exuberance, Irrational or Otherwise*, N.Y. TIMES, Dec. 17, 2001, at C11 (comparing the more recent sluggish stock market with the activity level of 1999 through 2000). *See also* Michael Lewis, *Five Lessons From the Internet Boom-and-Bust Commentary*, THE TORONTO STAR, Dec. 11, 2000, at 1 (discussing reasons for rising stock market during second half of 1990s); Interview by Margaret Warner with Gail Dudack of UBS Securities, *NewsHour with Jim Lehrer: Strength in Numbers; High-Tech Workers* (PBS television broadcast, Apr. 3, 1998) (noting S&P 500 stocks traded at "record multiples" and stating the valuation in 1998 was unprecedented).

4. *See infra* notes 28-29 and accompanying text (discussing losses suffered by investing employees).

the bases for that conviction and expands on some of the ideas introduced in my earlier article. The value of engaging in that exploration at this point in time is clear. Congress is in the process of considering 401(k) pension plan reform in the wake of the Enron debacle,[5] and the approach favored by the Republican House of Representatives centers on improved disclosure and investor education.[6] While many (including myself) are pessimistic that any legislation will pass this year,[7] passion for pension reform has been ignited and Congress will surely enact legislation this year or next. In doing so, it is important that Congress not limit itself to steps that give the appearance of reform but that will accomplish little.

Part I of the Article discusses employer securities' heavy role in 401(k) plans and the risks they create. Part II explores the reasons for such heavy investments in employer securities by 401(k) plan participants and discusses why, given those reasons, improved disclosure and education alone is not a sufficient response to the risks. Part III explains why ERISA's fiduciary standards do nothing to improve the situation.

This Article does not evaluate the arguments advanced by employers and others in favor of employee stock ownership, a subject worthy of its own separate treatment.[8] For purposes of this Article, I accept the notion that there are some benefits to encouraging employee stock ownership. What troubles me is attempting to achieve those benefits at the expense of employees'

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5. Since December 2, 2001, the date on which Enron filed for bankruptcy, at least twenty different bills have been introduced in the House and Senate to effect reform of 401(k) plan regulation. *See* SUSAN J. STABILE, 401(K) SPECIAL SUPPLEMENT: LESSONS FROM ENRON appendix E (Aspen forthcoming 2002).

6. On April 11, 2002, the House passed the Pension Security Act of 2002. *See* H.R. 3762, 107th Cong. § 213(a)(1)(A)(iii), § 104 (g)(1) (2002) (requiring all employers to provide participants with a quarterly benefits statement). The bill would also provide for a prohibited transaction exemption to allow the provision of investment advice by third party service providers to plans, as well as providing 401(k) plan lockdowns. The bill would also restrict how long employers can force employees to hold stock contributed as a matching contribution. *Id. See also* S. 1992, 107th Cong. § 201 (2002) (requiring the company to provide accurate investment information and to issue quarterly benefit statements).

7. The leading House and Senate bills, H.R. 3762 and S. 1992, are very far apart and reflect real political differences in approach. That, along with the fact that 2002 is an election year, make it very unlikely that compromise will be reached in the short term.

8. I have engaged in some evaluation of those claims, both in my earlier article on this subject and in testimony before the Senate Governmental Affairs Committee in February of this year. *See* Stabile, *supra* note 1, at 73-78; *Retirement Insecurity: 401(k) Crisis at Enron, Hearings before the Senate Governmental Affairs Committee* 107th Cong. (Feb. 5, 2002) (testimony of Susan J. Stabile), *available at* http://www.senate.gov/~gov_affairs/020502stabile.htm.

retirement security.

I. EMPLOYER SECURITIES IN 401(K) PLANS

A growing emphasis on employee stock ownership has accompanied the movement toward a shareholder wealth maximization view of the corporation.[9] Employers and investors believe that stock ownership by employees enhances worker productivity and motivation by giving employees a stake in the company's performance, thus aligning their interests with shareholders' interests. As a secondary motive, managers favor employee stock ownership because stock held by employees is viewed as stock held in friendly hands.[10]

An employer security stock fund in a 401(k) plan is a common means of putting stock in the hands of rank-and-file employees. Most large public companies' 401(k) plans have an employer security stock fund as one of the available investment options,[11] and employees directing their 401(k) plan contributions can invest

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9. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L. Q. 403, 405 (2001) (discussing broad acceptance of the notion that "shareholders alone are the *raison d'etre* of the corporation"); Lyman Johnson & David Millon, *Missing the Point About State Takeover Statutes*, 87 MICH. L. REV. 846, 848 (1989) (discussing notion of "shareholder primacy").

10. *See, e.g.*, U.S. DEP'T OF TREASURY, REPORT ON EMPLOYER STOCK IN 401(K) PLANS 3 (Feb. 28, 2002) (discussing employer beliefs regarding value of employee holdings of company stock); David Leonhardt, *Sweetening Pensions at a Cost to Workers*, N.Y. TIMES, Feb. 17, 2002, at § 3, p. 4 (discussing reasons employers like employees to hold company stock); Robert Luke, *Workers Still Want Company Stock Despite Enron Fall*, ATLANTA J. & CONST., Feb. 1, 2002, at 1C (citing President of 401(k) Association regarding employer expectation that employees with ownership stake are more loyal and productive, and that senior management likes stock in friendly hands). The merits of both of these positions can be debated. *See, e.g.*, Maya Kroumova, *Investment in Employer Strock Through 401(k) Plans: Is There Reason For Concern?* 111-21 (2002) (Unpublished Graduate School Dissertation, New Brunswick, on file with the author) (summarizing findings regarding effect of plan investments in company stock on productivity and noting own finding of no significant impact on company performance); David Millon, *Enron and the Dark Side of Worker Ownership*, 1 SEATTLE J. FOR SOC. JUSTICE (forthcoming 2002) (exploring negative aspects of claims supporting employee ownership). However, as I have indicated, for purposes of the present discussion, I will accept the proposition that there are values to employee stock ownership.

11. *See* Patrick J. Purcell, *The Enron Bankruptcy and Employer Stock in Retirement Plans*, CRS REPORT FOR CONGRESS, Jan. 22, 2002, at 3 (citing findings that 55% of plans offer employer stock as an investment option). *See also* Jack L. VanDerhei, *Company Stock in 401(k) Plans: Results of a Survey of ISCEBS Members*, EBRI SPECIAL REPORT, Jan. 31, 2002, at 4 (noting that 48% of respondents had a company stock options, and that those having options tend to be the largest plans). Because large plans are more likely than small ones to offer an employer stock fund, 75% of participants are in plans offering an employer stock fund. *Id.* at 10.

any or all of their contributions in employer stock.[12] Additionally, many companies automatically invest any matching contributions[13] in employer securities,[14] and often these companies impose long waiting periods before allowing employees to switch matching contributions into another investment alternative.[15]

As a result, many 401(k) plans are heavily invested in employer securities. Indeed, participants in 401(k) plans offering an employer stock option invest an average of 30-40% of their plan assets in company stock,[16] and at many companies, these

12. Plans containing a company stock fund generally allow participants to invest all, or any part, of their contributions in employer stock. Only 14% of plans impose any limits on the acquisition of company stock. Purcell, *supra* note 11, at 4.

13. Ninety-one percent of 401(k) plan participants are in plans with matching contributions. *See* Sarah Holden & Jack L. VanDerhei, *Contribution Behavior of 401(k) Plan Participants*, ICI PERSPECTIVES, Oct. 2001, at 2 (regarding reasons employer provide matching contributions). *See also* Richard J. Kovach, *A Critique of SIMPLE - Yet Another Tax-Favored Retirement Plan*, 32 NEW ENG. L. REV. 401, 402 n.13 (1998) (suggesting "employers sometimes make matching contributions to encourage [R&F] employees to elect deferrals sufficient to permit highly compensated employees to maximize their elective deferrals under this rule").

14. *See* Purcell, *supra* note 11, at 3-4 (noting that 45% of plans with an employer stock option require that all matching contributions be invested in company stock). *See also* VanDerhei, *supra* note 11, at 5 (noting that 43% of companies with a company stock option require matching contributions to be invested in company stock); Theo Francis, *Company Stock Fills Many Retirement Plans Despite the Potential Risks to Employees*, WALL ST. J., Sept. 11, 2001, at C1 (noting that many employers match employee 401(k) contributions with company stock and providing Gillette, Abbott Laboratories, and Coca-Cola as examples of such companies); Jim Davenport, *When All the Eggs are in the Company Basket*, CHI. TRIB., Aug. 14, 1995, at 3C (reporting finding of Buck Consultants that 18% of all companies surveyed, and 40% of the largest companies surveyed, matched contributions with employer stock). Aside from the desire to put stock in friendly hands, companies view matches in company stock as desirable from a tax and a cash flow standpoint. U.S. DEP'T OF TREASURY, *supra* note 10, at 3. *See also* Jeffrey N. Gordon, *Employees, Pensions and the New Economic Order*, 97 COLUM. L. REV. 1519, 1556 (1997) (noting the common practice of employer matching employer stocks at a discount as an incentive that works to the employers' benefit, but because it increases the concentration, it will reduce average returns and increase the risks to the employee).

15. *See* Purcell, *supra* note 11, at 6 (noting that 34% of companies that match in company stock require participants to reach a certain age – typically 50 or 55 – before they can sell the stock). *See also* VanDerhei, *supra* note 11, at 5 (noting that 60% of companies matching in company stock restrict sales until a specified age and/or service requirement is met).

16. Richard A. Oppel, Jr., *The Danger in a One-Basket Nest Egg Prompts a Call to Limit Stock*, N.Y. TIMES, Dec. 19, 2001, at C1 (noting that among plans permitting investment in company stock, 32% of plan assets are invested in that option and that in situations where employer mandates that match be made to employee's stock fund, more than 50% of plan assets are so invested). *See also* Vickie L. Bajtelsmit & Jack L. VanDerhei, RISK AVERSION AND

investments are closer to 80% or 90%.[17] According to a recent study of the approximately 23 million participants in plans offering company stock, 10.6 million participants have account balances that are more than 20% invested in company stock.[18] The 10.6 million breaks down as follows: 3 million participants hold 21-40% of their account balance in company stock; 2.3 million participants hold 41-60% of their account balance in company stock; and 5.3 million participants hold in excess of 60% of their account balance in company stock.[19] Even more distressing is that low-wage workers – those least likely to have adequate alternative sources of retirement income – are "three to four times as likely to have 80% or more of their plan assets invested in company stock than higher-wage workers."[20] In contrast to executives whose primary holdings in employer stock come from stock options and bonus stock, rank-and-file employees primarily own company stock through their 401(k) plan accounts.[21]

PENSION INVESTMENT CHOICES IN POSITIONING PENSIONS FOR THE TWENTY-FIRST CENTURY 45, 57 (Michael S. Gordon et al. eds., 1997) (finding 41-42% invested in employer securities); Virginia Munger Kahn, *The Perils of Company Stock for Retirement*, N.Y. TIMES, Mar. 16, 1997, § 3, at 6 (discussing employee investment); PENSION & BEN. DAILY REPORT, Jan. 18, 2002 (reporting IOMA study of 219 plans that found 25 to be more than 60% invested in company stock).

17. *See* Francis, *supra* note 14, at C1 (providing as examples of companies with heavy 401(k) plan accumulations of employer securities: Abbott Laboratories (90%); Pfizer, Inc., (85%); Anheuser-Busch Co. (82%); and Dell Computer Corp. (88%)). *See also Managing 401(k) Plans*, IOMA, Oct. 2001, at 3 (noting Proctor & Gamble and Sherwin Williams as examples of companies with more than 90% of 401(k) plan assets in employer securities and noting seven other plans with assets of at least 80% in employer securities). *See also* Francis, *supra* (reporting result of study of Institute of Management and Administration finding that the 401(k) plan assets of one in five companies is at least 50% invested in company stock); *Managing 401(k) Plans*, *supra* at 3 (noting that 30 of the plans tracked by IOMA have 60% or more of the assets invested in company stock).

18. Olivia S. Mitchell & Stephen P. Utkus, *Company Stock and Retirement Plan Diversification* 18 (Pension Research Council Working Paper 2002-4 Apr. 2002) *available at* http://prc.wharton.upenn.edu/prc/PRC/WP/WP2002-4.pdf.

19. *Id.*

20. Gordon P. Goodfellow & Sylvester J. Schieber, *Investment of Assets in Self-Directed Retirement Plans*, *in* POSITIONING PENSIONS FOR THE TWENTY-FIRST CENTURY 67, 86 (Michael S. Gordon *et al.* eds., 1997).

21. It is true that the number of employees who have been granted stock options by their employers has grown from about one million in 1992 to about ten million today. *See* National Center for Employee Ownership, *Employee Stock Options Fact Sheet, at* http://www.nceo.org/libarry/optionfact.html (reporting that up to 10 million employees receive stock options). According to a 1999 survey by William M. Mercer, 39% of large firms granted options to at least one-half of their employees in 1999 compared to 17% in 1993. *See* Margaret M. Engel, *Update on Trends in Stock Option and Long-Term Incentive Plans*, ACA J., July 1, 1999, at 4248 (citing a study by William Mercer). Whereas executives have the bulk of their stock ownership through

Because most Americans fail to accumulate significant retirement savings apart from their employer-sponsored pension plans[22] and because the future reliability of Social Security is in doubt,[23] it is important that employer-sponsored pension plan savings be sufficiently diversified to minimize losses of retirement income. Concentrating a significant portion of retirement savings into a single company stock creates a tremendous risk to a participant's retirement security.[24] Investment advisers

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options and bonus-stock and only a small percentage through their 401(k) plan, for rank-and-file workers the situation is reversed.

22. Americans' savings rate is generally so low that such funds are vastly insufficient to afford a comfortable retirement. *See, e.g.*, Lewis Keller, *Sound Investment Policies for an Aging Population*, SAN FRAN. BUS. TIMES, July 19, 1996, at C3, *available at* 1006 WL 10042468 (noting that although a retiree needs $1 million in savings to generate $50,000 a year in retirement income, three out of four workers in 1996 admit that their savings are inadequate); Diane E. Lewis, *New To The Workforce? Start Savings Plan Now,* BOSTON GLOBE, July 9, 1996, at C3 (reporting a 1995 Rand Corporation study finding that the rate of savings among Americans has dropped to 4% of annual income in 1993 from 6.4% in 1959); *Good Savings Habits Can Never Start Too Soon for Your Child*, TAMPA TRIB., July 17, 1996, at 7 (reporting Commerce Department figures for the first quarter of 1996 showing that Americans save less than 4% of every dollar, in comparison to 15.3% in Japan and 8.3% in Canada). The reality is that most workers find it difficult to accumulate personal savings for retirement benefits because "their paychecks are used to meet the demands of day-to-day living expenses." *Democratic Leadership Introduces Clinton's Pension Reform Package,* BNA PENSIONS & BENEFITS DAILY, May 28, 1996, at 23 (quoting Sen. Thomas A. Daschle). [herinafter, *"Clinton's Pension Reform"*].

23. *U.S. Senator Joseph Lieberman (D-CT) Holds Hearings on Enron 401(k) Plans: Hearings Before the Senate Governmental Affairs Comm.*, 107th Cong. 5 (2002) (statement of Sen. Joseph Lieberman concerning hearing on Enron 401(k) plans, stating, "[w]ith the concerns about the long-term stability of the Social Security fund and personal savings rates at just 1.1 percent, which is a historical low, we really need to get 401(k) reform right.") [hereinafter *"Senate Enron Hearings"*]. *See also* Jonathan Riskind, *Deficit Could Hurt Fix for Medicare, Social Security*, THE COLUMBUS DISPATCH, Jan. 28, 2002, at 1A (noting that by 2025 the cost to keep the trust would be $579 billion per year); Keller, *supra* note 22, at C3 (reporting a 1995 Rand Corporation study reporting that the Social Security Administration is in such bad shape it might not be around in 50 years); *Hearings before the Senate Finance Committee on Social Security and Family Policy*, 106th Cong. 1 (Mar. 25, 1996) (testimony of Olivia A. Mitchell) (citing projection of Social Security trustees that Social Security tax revenue will be less than currently-legislated benefits after the year 2013, and that the Social Security trust fund will be depleted by 2030). In any event, Social Security alone, which provides an average of 40% of pre-retirement income, does not provide sufficient retirement income. *See Clinton's Pension Reform*, *supra* note 22, at 23.

24. *See* Shlomo Benartzi, *Excessive Extrapolation and the Allocation of 401(k) Accounts to Company Stock,* 55 J. OF FIN. 1747, 1747 (2001) (citing Brennan and Torous findings that "the certainty equivalent of investing one dollar in a single stock over a 10-year period is only 36 cents"); Mitchell & Utkus, *supra* note 18, at 2 (noting that a defined contribution plans with concentrated company stock holdings will produce lower median wealth than a

recommend that "company stock should account for as little as 5% but no more than 20% of a plan's total assets. Some say company stock should not be in a 401(k) plan at all."[25]

Insufficient diversification of 401(k) assets may not be so much of a problem for executives of a company, who tend to have a relatively small percentage of their retirement portfolio bound up in their plan. A company's highest paid officers may receive in excess of 50% of their total pension benefits from nonqualified plans.[26] However, rank-and-file employees depend almost exclusively on their 401(k) plan to accumulate retirement savings. It is important in this context to realize that defined contribution plans were once viewed as supplemental retirement vehicles, a 401(k) plan is the sole source of employer-sponsored retirement income for many employees and the primary source for many others.[27]

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system of diversified investments). RiskMetrics, a software analytics company has found that weighing all the Dow Jones stocks, a 1/3 holding in a 401(k) plan in a single stock would produce an average 21% more risk than a portfolio that reflected the overall market and that concentrated holdings in NASDAQ stocks pose an even greater risk. *See* Kurt Eichenwald, *Enron's Collapse; Audacious Climb to Success Ended in a Dizzying Plunge*, N.Y. TIMES, Jan. 13, 2002, § 1, at 1 (describing Enron employees' stories of financial loss). It may be that at any given time, concentrated holdings in certain individual stocks do not pose a greater risk than a diversified portfolio. However, not only is it difficult to predict which those companies will be, but over time, most stocks will suffer a serious downturn. *See* Luke, *supra* note 10, at 1C (noting that every stock, given a 20-30 year time period, will decrease 20%). Thus, depending on the age of the participant when the fall occurs, the participant will not be able to wait for a recovery.

25. Susan Strother Clarke, *Area Workers' 401(k)s Bet on Employer Stock*, ORLANDO SENTINEL, Mar. 3, 2002, at A1. *See* Mitchell & Utkus, *supra* note 18, at 2 (noting that the "risks of company stock are not limited to plans or accounts with high current levels of concentration," and observing that stock concentrations will be low in the plan of a company whose stock has performed poorly over a long period, "yet participants will have suffered real economic losses due to a gradual decline in a stock's value").

26. Kenneth A. Kirk & William J. Bowden, *Finding and Fixing "Broken" Nonqualified Plans*, EMPLOYEE BENEFITS J., Dec. 1, 2001, at 16.

27. Susan J. Stabile, *Paternalism Isn't Always a Dirty Word: Can the Law Better Protect Defined Contribution Plan Participants?*, 5 EMPLOYEE RIGHTS AND EMP. POLICY J. 491, 496 (2001). *See* Clarke, *supra* note 25, at A1 (citing Profit Sharing/401(k) Council of America that 401(k) plans are now the predominant form of retirement savings, and have largely replaced conventional pensions). Section 401(k) plans now have about $2 trillion in assets and cover over 42 million participants. Investment Company Institute, *401(k) Plan Participants: Characteristics, Contributions and Account Activity*, ICI PERSPECTIVES, Oct. 2001, at 1. Defined contribution plan assets have outstripped those of defined benefit plans. *See* Christiane Bird, *401(k)s Adopting Traditional Pension Plans' Techniques*, DOW JONES NEW SERVICE, Jan. 17, 2002 (noting that defined contribution plans now have $2 trillion in assets, compared to $1.8 trillion for defined benefit plans). This is a vast change from the mid 1970s, when defined benefit plan assets stood at about

Over-investment in employer securities by pension plans is even more potentially damaging than a general lack of diversification in an investment portfolio. Significant accumulation of employer securities puts all of one's eggs (present job security and future retirement security) in a single basket, which no investment adviser would recommend. This is not a speculative danger. Anyone who has read the newspaper in recent months has heard stories about evaporating plan account balances of employees of companies like Lucent Technologies, Polaroid, and Enron.[28] In hearings before the Senate Governmental Affairs Committee on February 5 of this year, a union representative testified regarding losses suffered by Enron plan participants, highlighting the fate of eight employees, who together lost $2,882,000 as a result of Enron's collapse.[29]

A second problem with over-investment in employer securities by 401(k) plans is that company managers are subject to less shareholder oversight if large concentrations of company stock are owned by employees. In fact, employers often include company stock funds as a 401(k) investment option precisely as a means of placing large blocks of shares in friendly hands.[30] Employers believe that employees will be more concerned with current job security than with the future value of their retirement benefit, and thus will make voting and tender decisions that favor the current management's interests.[31] Employees often have strong feelings of identification with their employer and "derive psychological or emotional benefit from making decisions they perceive to be in the best interests of current management."[32] At a minimum, employee shareholders are less likely to challenge management. According to survey results of the Employee Benefits Research Institute, 64%

$186 billion and defined contribution plan assets at $74 billion. David A. Pratt, *Nor Thyme Nor Reason: Simplifying Defined Contribution Plans,* 49 BUFF. L. REV. 741, 750 (2001).

28. *See, e.g.*, Oppel Jr., *supra* note 16, at C1 (discussing losses suffered by employees of Lucent, Nortel, Global Crossing and Enron due to heavy concentrations of accounts in employer securities).

29. *Senate Enron Hearings*, *supra* note 23, at 10-12 (testimony of William D. Miller, business manager and financial secretary for the International Brotherhood of Electrical Workers Local 125). It is possible to quibble with the calculation of the loss figures. Some of the figures being cited calculate loss based on the fall from the highest price at which Enron's stock was trading. Employees purchased much of their company stock at a price much lower than that high price, benefiting from the tremendous run up in the price of the stock during the company's meteoric rise. Nonetheless, by the end of the day, a large number of Enron employees were left with 401(k) plan accounts that were essentially wiped out.

30. *See* Stabile, *supra* note 1, at 90 (discussing entrenchment impact of plan investments in employer securities).

31. *Id.*

32. *Id.* at 103.

of surveyed plan participants indicated that they would not vote in favor of acquisition of their employer by a hostile acquirer even if doing so would result in a 100% return on their investment.[33]

Thus, both concerns about ensuring adequate retirement income and corporate governance concerns argue against overweighting 401(k) plan account balances with employer stock. The next question is whether improving disclosure and providing greater education and advice to plan participants will effectively address those concerns.

II. THE LIMITS OF IMPROVED DISCLOSURE AND EDUCATION

A. *Reasons for Heavy 401(k) Plan Investments in Employer Securities*

What explains the significant accumulation of employer securities in 401(k) plans? Offered the option of investing all or part of their plan contributions in employer securities, why do so many employees choose to invest such a large percentage of their retirement savings in that option? Is it simply that no one has ever told employees that diversification is important, or is something else operating? Several things explain the heavy investment in employer securities.

Context-Dependence. Behavioral theorists have empirically demonstrated that the options presented to a decisionmaker and how those options are presented affect the decisionmaker's choices, a phenomenon known as "context-dependence."[34] Context-dependence is no less a reality in the context of participant investment decisions than in other areas. The Employee Benefits Research Institute (the "EBRI") has found support for the influence of the options presented to the decisions made by plan participants. EBRI compared plans offering guaranteed investment contracts and employer stock funds with plans offering only one or the other or neither choice. It found that plans offering neither option have the highest allocations to equity funds, whereas the presence of either a GIC fund or an employer stock

33. Employee Benefit Research Institute, *Public Attitudes on Employee Ownership and Benefit Promises*, 1994 EBRI/GALLUP REPORT G-54 at 22.

34. *See* Mark Kelman, Yuval Rottenstreich & Amos Tversky, *Context-Dependence in Legal Decision Making*, 25 J. LEG. STUD. 287, 288 (1996). Numerous studies have established that "people's preferences are affected by the set of options under consideration." Amos Tversky & Itamar Simonson, *Context-Dependent Preferences*, 39 MGMT. SCI. 1179, 1187 (1993). I discuss context-dependence more fully in Susan J. Stabile, *Freedom to Choose Unwisely: Congress' Misguided Decision to Leave 401(k) Plan Participants to Their Own Devices,* 11 CORNELL J. OF L. & PUB. POL'Y 361, 378-86 (2002) (arguing that context-dependence destroys the theoretical basis for section 404(c) of ERISA).

fund, but not the other, resulted in substantially lower allocations to all other funds.[35] Professors Benartzi and Thaler have also illustrated how the options presented to the plan participant affect decision-making. They conducted a study that found that whether a investment option is framed as a middle choice or as an extreme choice affects participants' preference for the option.[36] In another study, they found that the number of investment options offered in a particular category of investment affected overall allocation of funds to that investment category. Thus, for example, increasing the number of equity funds offered resulted in an increase in the total percentage of a participant's account balance allocated to equity funds.[37]

Of more relevance to the issue of over-investments in employer securities, the EBRI study also found that participants directed a higher percentage of their own contributions to employer stock in plans that automatically invest a company's matching contribution in employer securities.[38] In these situations, participants invest 33% of their contributions in company stock, compared to 22% when the match is not in employer securities.[39] One explanation for this phenomenon, referred to by Professor Schlomo Benartzi as an "endorsement effect," is that participants interpret matches in employer securities "as an endorsement or as implicit investment advice."[40] Since 45% of companies with employer stock funds require matching fund investment in company stock,[41] the potential endorsement effect is tremendous.

Optimistic Bias. Many employees invest heavily in their employer's stock because of overconfidence in the employer, which

35. *See* Susan J. Stabile, *The Behavior of Defined Contribution Plan Participants,* 77 N.Y.U. L. REV. 71, 87 (2002) (discussing the EBRI findings).

36. Shlomo Benartzi & Richard H. Thaler, *How Much is Investor Autonomy Worth?*, Mar. 2001, at 18-20, available at http://gsbwww.uchicago.edu/fac/richard.thaler/ research/Autonomy.pdf.

37. Shlomo Benartzi & Richard H. Thaler, *Naïve Diversification Strategies in Defined Contribution Savings Plans*, 91 AMER. ECON. REV. 79, 89 (Mar. 2001).

38. *See* Stabile, *supra* note 35, at 87 (discussing the EBRI findings).

39. *See* Holden & VanDerhei, *supra* note 13, at 10 (discussing why employers provide matching contributions). *See also* Daniel Altman, *Enron's Collapse: Pensions; Experts Say Diversify, But Many Plans Rely Heavily on Company Stock,* N.Y. TIMES, Jan. 20, 2002, § 1, at 26 (noting that participants invest 47.6% of their contributions in plans requiring a match in employer securities compared to 20.2% in plans that do not contain such a requirement).

40. Benartzi, *supra* note 24, at 1752. Professor Benartzi's own studies find a similar endorsement effect from company matching contributions in other types of funds. *Id.* at 1752-54.

41. *See* Purcell, *supra* note 14, at 3-4 (noting that according to a study by Hewitt Consultants, 45% of plans offered by 55% of companies surveyed made matching contributions exclusively in company stock).

can be viewed as a version of the optimistic bias.[42] This theory holds that employees think that other companies are more likely to experience problems than their own. Employees recognize in the abstract both that diversification of investments is desirable and that they should be invested in equities. However, they fear the unknown and feel greater comfort and certainty with their employer's stock believing it to be less risky than other stocks.[43] For example, a Vanguard Group study found that although plan participants rate individual stocks as more risky than a stock mutual fund, they consider their own employer's stock as less risky than a diversified fund.[44]

This overconfidence in the employer may thus be a product of bounded rationality;[45] participants know they lack the ability to suitably judge the entire array of investment choices so participants substitute confidence in the employer instead.[46] However, in many cases the overconfidence in the employer is the result of employees excessively extrapolating from past performance, incorrectly believing that the fact that an employer's stock has done well in the past means there is less risk in the future.[47] Since the prolonged bull market resulted in many companies experiencing sustained positive returns, many

42. BEHAVIORAL LAW & ECONOMICS 4 (Cass R. Sunstein, ed., Cambridge Univ. Press 2000).

43. *See* Jim Gardner, *ESOP Fables Sometimes Lack a Happy Ending*, S.F. BUS. TIMES, Feb. 7, 1997, at 3 (noting that risk of lack of diversification of investment in employer securities is magnified by the fact that employees "tend to have rosier views of the prospects for their companies than might be warranted"). *See also* Jeffrey M. Laderman, *More Gold for Your Golden Years*, BUS. WK., July 3, 1995, at 63 (noting that employees "don't think employer securities are risky because they understand the company. They think the stock market is risky because they don't understand it.").

44. *See* Mitchell & Utkus, *supra* note 18, at 30 (reporting results of 2001 Vanguard Group study and similar findings by a John Hancock 2001 study).

45. Christine Jolls, Cass R. Sunstein & Richard H. Thaler, *A Behavioral Approach to Law & Economics, in* BEHAVIORAL LAW & ECONOMICS 14-15 (Cass R. Sunstein, ed., Cambridge Univ. Press 2000).

46. *See, e.g.*, Robert L. Clark & Madeline B. d'Ambrosio, *Financial Education and Retirement Savings*, TIAA-CREF WORKING PAPERS, (TIAA-CREF, New York, NY), Feb. 2002, at 13 (writing that most participants have limited knowledge of financial markets or the risks associated with various investment options and have little understanding of how much they need to save); Clarke, *supra* note 25, at A1 (noting that employees feel comfortable with the company they know); Luke, *supra* note 10, at 1C (citing Hewitt Associates Lori Lucas that participants feel overwhelmed by plan choices and can not determine how various options fit into their portfolio).

47. Professor Benartzi's empirical findings support this conclusion. *See* Benartzi, *supra* note 24, at 1748-49 (stating that employees "conclude that abnormally high past performance is representative of future performance, even though stock returns are largely unpredictable"). *See also* Investment Company Institute, *supra* note 27 (reporting that 34% cite company's past performance as reason for investing in company stock).

employees came to believe that an investment in their employer's securities was a sure bet.

Loyalty. Many employees invest heavily in employer stock because of loyalty to their employers,[48] an example of bounded self-interest.[49] Employees feel that they "owe something to the company" and therefore should invest in company stock.[50] Loyalty is particularly an issue for women, who make up a growing part of the workforce,[51] but it is by no means limited to women.[52] Employees testifying during Enron hearings talked about the culture of employee stock ownership and the feeling of trust in the company and its leaders that pervaded the work environment.[53]

Pressure. This is a much harder phenomenon to document, but there is certainly widespread belief that employers engage in "workplace campaigns to pressure employees to invest their own money in the company."[54] For example, in a press conference announcing his pension reform bill in March of this year, Senator Kennedy stated that "the main reason why Enron workers lost more than a billion dollars is that they were pressured by Enron

48. *See* Lewis Braham, *Institutional Asset Management: The Growing Number of Options in Qualified Plans is a Boon for Planners in the Short Run But Could Spell Trouble in the Long*, FIN. PLAN., July 1, 1997, at 7 (explaining that despite lack of diversification, employees over invest in employer securities because "often even the most sophisticated employees remain doggedly loyal to their mother company"). *See also* Adam Bryant, *Betting the Farm on Company Stock*, N.Y. TIMES, Apr. 16, 1995, § 3, at 1 (stating that for many employees, the issue is emotional; employees invest heavily in employer securities even though they say they would never advise a relative to be so heavily invested in a single stock).

49. *See* Jolls, Sunstein & Thaler, *supra* note 45, at 16.

50. Clarke, *supra* note 25, at A1 (quoting Professor Patricia Dilley).

51. *See* Debora Vrana, *Investing with Cash, Hearts and Souls*, L.A. TIMES, Feb. 25, 1997, at A1 (quoting financial planner Esther Berger's observation that "women invest with their souls and their hearts rather than their pocketbooks alone").

52. *See* Braham, *supra* note 48, at 7 (giving example of a GM executive who, despite his participation in all discussions with analysts about the company's financial prospects, insisted on investing enormous amounts in GM stock as the stock was falling, thus losing $160,000 of his retirement money).

53. *Senate Enron Hearings*, *supra* note 23, at 13-16 (statement of Deborah G. Perotta, a former senior Administrative Assistant at Enron, referring to Enron as a family that rewarded employee loyalty and hard work with large compensation and benefits packages that, in turn, created an "atmosphere of great pride, trust and respect"). *See also* Anthony Violante, *Enron's Crash Turned Media 'From Lap Dogs to Attack Dogs*, THE BUFFALO NEWS, Feb. 15, 2002, at C4 (quoting former Enron employee, single-mother, Helen Matthews saying "what hurts almost as much [as losing her job] is that working at Enron was like being part of [a] community. We cared about each other.").

54. *Retirement Policy: Industry Groups Cite 401(k) Plan Successes; AFL-CIO Says Enron Problems not Isolated*, BNA PENSIONS & BENEFITS DAILY, Mar. 6, 2002 (citing AFL-CIO Secretary-Treasurer Richard Trumka).

executives to put all their 401(k) money in company stock."[55] Allegations of employer pressure have also been advanced in several of the lawsuits recently filed against employers by participants who have suffered heavy plan losses as a result of downturns in the employer's stock.[56] In addition, practices such as requiring employees to invest matching contributions in company stock and offering company stock at a discount to employees[57] suggest efforts by employers to influence employees to invest in employer stock.[58]

Anecdotal evidence suggests that even where there is no overt pressure, employees feel that they must invest in company stock in order to be perceived as loyal to their employer. It was my experience when I was in law practice that when a company puts a stock fund in a 401(k) plan, many employees, particularly low-level managerial employees, felt pressured to put a lot of their

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55. Press Conference, Senator Ted Kennedy (D-MA), Senator Jeff Bingaman (D-NM), Senator Jon Corzine (D-NJ) and Senator Barbara Boxer (D-CA) FEDERAL NEWS SERVICE (Mar. 6, 2002).

56. For example, a lawsuit filed against Lucent Technologies alleges such manipulation. In *Reinhart & Smith v. Lucent Technologies, Inc.*, Civ. 01-CV-3491 (D.N.J. 2001), the complaint alleges that Lucent induced plan participants to invest in, or continue to invest in, Lucent stock despite the fact that the company knew of serious business problems that would adversely affect the value of the stock. A similar such action was brought against Ikon Office Solutions, and a class certified in 2000. In *re Ikon Office Solutions, Inc.*, 191 F.R.D. 457 (E.D. Pa. 2000). The Ikon litigation was recently settled, with the company agreeing to make certain changes to its 401(k) plan, including allowing participants with at least two years of service to invest company matching contributions in funds other than employer securities. *Ikon Settles ERISA Litigation,* BUSINESS WIRE, May 14, 2002. Similarly, allegations brought by Nortel employees against the company included claims of misrepresentation and failure to disclose material information. The allegations also claimed Nortel director's "failure to diversify" contributed to the risk of large losses. Kauffmann v. Nortel Networks Corp., No. 3-02cv253 (M.D. Tenn. filed Mar. 20, 2002). The recent filing of a class-action lawsuit against Global Crossing directors brought by the company's employees extends the claim to the accounting firm for violating the Racketeer Influenced and Corrupt Organizations Act by endorsing misleading and false information. Ghazee v. Winnick, No. 2-02cv070 (C.D. Cal. filed Mar. 14, 2002).

57. *See* Gordon, *supra* note 14, at 1555 (suggesting that one of the reasons so much 401(k) money is invested in employer securities is that employers often offer stock to employees at a discount).

58. *See* Mitchell & Utkus, *supra* note 18, at 31 (noting that employees may be "encouraged through management promotion of the stock, and possibly organizational pressure to buy and own shares in the company"). Employers certainly have an incentive to pressure employees. As one commentator observed, "If you take a company that has 30,000 or 40,000 employees, and all of those people are buying the stock, that supports the price and makes the company look better. A lot of CEOs get paid on the basis of the stock price, so there's an incentive to do that." Ed Taylor, *Pension Groups Worry About Congressional Interference after Enron*, KNIGHT RIDDER/TRIB. BUS. NEWS, Mar. 4, 2002 (quoting James Dew, director, Financial Planning Association).

plan assets into that investment option. In addition, employees feel peer pressure from their co-workers to invest in company stock.[59]

B. *Improved Disclosure and Education are Unlikely to Be Effective*

Many people view 401(k) plan investment as a matter of individual choice. They reject the notion that any sort of limits should be placed on participant plan investment activity, instead favoring efforts to allow participants to make better choices.[60]

ERISA does not require employers to periodically disclose to 401(k) participants their account balances. In fact, the statute does not actually require disclosure unless the employee makes a request.[61] Any participant who does submit a written request for information regarding their account balance must be provided with one. However, ERISA imposes a limit on one request per year.[62] Despite the lack of a legal mandate, most 401(k) plan sponsors automatically provide statements on a quarterly or annual basis.[63]

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59. *See* Luke, *supra* note 10, at 1C (quoting president of 401(k) Association regarding peer pressure from fellow employees to buy company stock).

60. This inclination comes from a view of plan participants as rational decisionmakers capable of acting in a manner that will maximize their self-interest. As expressed in a recent Treasury Department report, 401(k) plans provide participants with the ability to "choose the tradeoff between risk and return that suits them best. It also allows individuals to adjust their portfolios from one with higher potential returns and higher risk early in their careers to one that provides smaller but surer returns as they approach retirement." U.S. DEP'T OF TREASURY, *supra* note 10, at 2. *See also* Karen W. Ferguson, *Rewriting the Rules on Retirement: How 401(k)'s Hurt Lower-Paid Workers,* N.Y. TIMES, Apr. 27, 1986, at C2 (noting that one reason 401(k) plans are so popular is that "they fit in perfectly with traditional notions of self-reliance and rugged individualism"). However, as I have argued at more length elsewhere, participant investment decisions are anything but the product of rational decisionmaking. *See* Stabile, *supra* note 35, at 88-92. *See also* Dana M. Muir, *The Dichotomy Between Investment Advice and Investment Education: Is No Advice Really the Best Advice?*, 23 BERKELEY J. EMPL. & LAB. L. 1, 18 (2002) (noting that both theory and empirical evidence "indicate that individual employees face numerous challenges in making investment allocation decisions"). The other problem with this view, is that it fails to appreciate the externalities resulting from poor employee plan investment choices. However, the government heavily subsidizes tax-qualified retirement plans precisely because there is a societal interest in ensuring adequate retirement security. If individuals do not retire with sufficient retirement savings, the government will be forced to provide for them, imposing costs on society as a whole. *See* Stabile, *supra* note 34, at 394.

61. *See* 29 U.S.C. § 1105(a) (2000).

62. *Id.*

63. *See* STEVEN J. FRANZ ET AL., 401(K) ANSWER BOOK, 18-18 (Panel Publishers 2002) (stating that although no provision requires individual participant statements, "from a practical standpoint, administers of 401(k)

There is also no requirement that employers provide any investment education or advice to their plan participants.[64] However, despite the fact that the law does not require them to do so, many employers do provide some type of investment education to their 401(k) plan participants.[65] Typically this includes information about the plan's investment options, general information about financial markets and economic conditions, and financial education or retirement seminars.[66]

The leading proposals for 401(k) plan reform focus on disclosure and education.[67] This is an unfortunate focus if the aim is true pension reform; improved education is unlikely to be effective in reducing the concentration of employer securities in participants' 401(k) accounts. As a general matter, the effectiveness of investor education generally is very mixed. While there is some evidence that education has positive impacts on participants' participation and contribution rates,[68] it is much less

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plans will provide such information on an automatic basis at least annually"). *See also The Gottesdiener Law Firm Announces Class Action Lawsuit Against Enron,* BUSINESS WIRE, Nov. 26, 2001 [hereinafter, "*Gottesdiener Law Firm*"] (quoting Gottesdiener's sentiment that "Congress sensibly placed a 10% limit on company stock in traditional defined benefit plans back in 1974, but at the behest of the corporate lobby, it placed no such cap on defined contribution plans. Today, when workers have been forced to assume virtually all of the investment risk and responsibility for funding their retirements, having no such cap is completely indefensible").

64. *See* Stabile, *supra* note 34, at n. 59 (noting the regulations are silent on the question of education, but they specifically state that a fiduciary is under no obligation to provide any investment advice to a participant. *See Also* 29 C.F.R. § 2550.404c-1(c)(4) (2001)).

65. Jacqueline M. Quinn, *Mainstreaming Financial Education as an Employee Benefit,* J. FIN. PLAN., May 2000, at 70-71. *See also* Gary Blau & Jack L. VanDerhei, *Employer Involvement in Defined Contribution Investment Education,* BENEFITS Q., Fourth Quarter 2000, at 84-85 (explaining that company human resource departments generally educate employees).

66. Clark & d'Ambrosio, *supra* note 46, at 5. Under current law, employers are prevented from offering specific investment advice without becoming fiduciaries and therefore facing liability for losses occasioned by participant decisions. To avoid fiduciary status, they are limited to providing generalized information about asset allocation and plan investment choices that do not sufficiently satisfy employee's need for education. *See* DOL Interpretive Bulletin 96-1, 29 C.F.R. § 2509.96-1 (1996). *See infra* notes 76-77 and accompanying text (discussing how employers do not offer programs or offer only limited programs as a result of potential liability).

67. *See infra* note 6 (discussing congressional proposals in the House and Senate).

68. James J. Choi, David Laibson, Brigitte C. Madrian & Andrew Metrick, *Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance,* NBER WORKING PAPER SERIES, 5, 28-31 Working Paper 8655, Dec. 2001, *available at* http://www.nber.org.papers/w8655 (discussing evidence of positive effect on participation and contribution activity, but criticizing studies). *See also* Clark & d'Ambrosio, *supra* note 46, at 4-5 (discussing studies finding positive effect of education on participation

clear that education has a positive impact on participants' investment behavior.[69] For example, according to a study of participants by the Investment Company Institute, 60% of participants in 401(k) plans never make any changes to their initial contribution and investment decisions.[70] This remains true even when employees are provided with investment education. In these instances, plan participants often say that they plan to make changes to their investment allocation, but very few of them actually make any changes.[71]

More importantly, education is particularly unlikely to affect decisions with respect to investments in employer securities. As discussed in the previous section, employees invest a significant portion of their 401(k) account balances in employer securities for a number of reasons. Although education may positively impact behavior that is the product of bounded rationality, many of the behavioral tendencies that result in heavy investments in employer securities have little to do with lack of financial sophistication or investment education. For example, so long as employers continue to make matching contributions in employer securities, the endorsement effect will cause employees to invest more of their own contributions in company stock. Similarly, behavior that is the product of optimistic biases is particularly resistant to change through educational efforts.[72] As one Home Depot employee who invested his entire 401(k) plan account into

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and contribution decisions).

69. *See Mind the Gap! Why DC Plans Underperform DB Plans, and How to Fix Them*, INVESTMENT INSIGHTS, Apr. 2000, at 11 (discussing failure of participant education efforts). *See also Worker Investment Decisions: An Analysis of Large 401(k) Plan Data*, at 4-5, 8, 11, & 13 (EBRI Issue Brief No. 176, Aug. 1996) (discussing study findings that show failure of participants to invest any plan assets in equities despite participant education efforts); Jeannie Mandelker, *Crossing the Line*, CFO MAG., Dec. 1, 1998, at 61 (although employees have received various forms of investment education for several years, their plan investment decisions have not improved); Gordon, *supra* note 14, at 1557 (noting that despite more investment in education activity being carried on by employers, employees continue to invest too little in equity securities). *But see* Muir, *supra* note 60, at 20-21 (stating that the method by which employers provide information "will influence the [employee's] selection of investment vehicles").

70. Investment Company Institute, *supra* note 27, at 6 *See also* Colleen E. Medill, *The Individual Responsibility Model of Retirement Plans Today: Conforming ERISA Policy to Reality*, 49 EMORY L.J. 1, 25 & n. 146 (2000) (citing EBRI findings that many employees change their plan investment allocations based on educational materials, but that those changes are not necessarily ones that positively affect account balances).

71. *See* Choi et al., *supra* note 68, at 30-31.

72. *See generally* Neil D. Weinstein & William M. Klein, *Resistance of Personal Risk Perceptions to Debiasing Interventions*, 14 HEALTH PSYCHOL. 132 (1995) (reporting on the results of several studies that failed to reduce optimistic biases).

company stock observed, "I just believe in the company . . . I don't want to really diversify my 401(k)."[73]

Finally, providing employees with general investment information and asset allocation models does not get at the root of their decisions that are the result of emotional and psychological factors such as loyalty to, and pressure by, the employer. As a result, even employees who are generally sophisticated and who appreciate the dangers of excessive investment in a single stock over-invest in employer securities.[74] This over-investment continues despite attempts to educate employees.[75]

Employers who wish to provide education to their plan participants without being viewed as fiduciaries responsible for participants' investment decisions are limited in the types of advice they can provide. In 1996, the DOL issued an interpretive bulletin relating to participant investment education[76] describing various categories of information and materials that employers may provide to participants without giving investment advice within the meaning of ERISA and the DOL's regulations. The information employers can provide includes plan information, information about general financial and investment concepts, asset allocation models providing strategies for obtaining hypothetical investment objectives, and interactive investment materials.[77] Essentially, the bulletin allows generalized investment education, but not for individualized investment advice.

Present law allows employers to provide investment advice for their employees, so long as independent advisers provide it. However, very few employers do so. According to a recent survey,

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73. Luke, *supra* note 10, at 1C.

74. Even executives running companies are susceptible to poor judgment regarding investments in employer securities. The New York Times recently reported on three chief executive officers whose unwarranted faith in their companies caused them to tie up significant portions of their wealth in employer securities, and use those securities to secure large loans. When their companies failed, they found themselves in deep financial trouble. *See* Floyd Norris, *3 Ex-Chiefs Discover Perils of Borrowing and Believing*, N.Y. TIMES, May 16, 2002, at C1.

75. *See* Ellen Benoit, *Too True to be Good*, CFO MAG. FOR SENIOR FIN. EXECUTIVES, Aug. 1, 1997, at 4 (stating employees continue to invest heavily in employer securities despite the fact that employers have "stepped up efforts to provide investment education, especially since the adoption of rule 404(c) in 1992").

76. U.S. DEP'T OF LABOR INTERPRETIVE BULL. 96-1, 29 C.F.R. § 2509.96–1 (1996). The DOL noted in the bulletin that "many employers have not offered programs or have only offered limited programs due to uncertainty regarding the extent to which the provision of investment-related information may be considered the rendering of 'investment advice" under Section 3(21)(A)(ii) of ERISA, resulting in fiduciary responsibility and potential liability in connection with participant-directed investments." *Id.*

77. 29 C.F.R. § 2509.96–1(d)(4) (2002).

only 22% of employers provide their employees with access to professional investment advice,[78] primarily because they fear liability if the adviser breaches its fiduciary duty to investors.[79]

Recognizing the limitations in the education employers can provide their employees, as well as their general reluctance to provide investment advice, Congress is considering legislation intended to provide more meaningful investment education and advice to 401(k) plan participants. The Pension Security Act of 2002, which passed the House on April 11, 2002, would allow the same companies who administer 401(k) plans and sell investment products to provide investment advice to plan participants, as long as any conflict of interest is disclosed to participants. It also clarifies that employers have no fiduciary liability for advice provided by such advisers as long as the employer prudently selects the adviser.[80]

This approach, however, creates more problems than it solves. Putting participants "in the hands of people who have a vested interest in directing them in a particular direction"[81] is clearly dangerous and a number of people have expressed concern about letting investment product retailers provide investment advice.[82] A disclosure requirement is the sole check on the conflict created

78. *See* Press Release, Rep. John Boehner, Boehner-Hutchinson Dear Colleague Letter to Senators on the Retirement Security Advice Act (May 13, 2002) (citing Profit Sharing/401(k) Council of America 2001 Investment Advice Survey, released Jan. 2002). *See also* Beth Kobliner, *Investing in 401(k)'s, Whose Advice is Best?,* N.Y. TIMES, Oct. 21, 2001, § 3, at 6 (discussing the current restrictions on giving employees investment advice and citing Profit Sharing/401(k) Council of America statistic which states that although almost all plans offer some type of investment education, "only 35 percent of 909 plans surveyed offer specific recommendations about where to invest").

79. *See* Muir, *supra* note 60, at 21-22 (describing potential employer liability for actions of investment advisers).

80. H.R. 3762 107th Cong. (Feb. 14, 2002).

81. 147 CONG. REC. 8189-02, 8196 (Nov. 15, 2001), (statement of Rep. McDermott). *See* Muir, *supra* note 60, at 37 (providing as an example that "if the adviser also is a member of the firm whose mutual funds are offered as plan investments, there may be explicit or implicit pressure to steer plan investors to funds that generate high fees for that mutual fund company").

82. *See, e.g.*, Christiane Bird, *Retirement Security Advice Act Draws Mixed Reactions*, DOW JONES NEWS SERVICE, June 25, 2001 (noting that many oppose allowing investment managers who serve as advisors to pension plans to recommend their own investment product and not requiring plan sponsor to monitor the advice provided); Lisa Singhania, *Legislation May Affect Mutual Funds*, ASSOCIATED PRESS June 27, 2001, *available at* 2001 WL 24029657 (citing opponents of a bill who argue that the bill "strips employees of protections from conflicts of interest by removing the prohibition against investment advisers recommending products they sell); Fran Hawthorne, *Saving; First Came 401(k)'s Now Some Advice*, N.Y. TIMES, Mar. 12, 2002, § G, at 2 (discussing the costs associated with investment advisors, noting the internet is now being used as an advisor, and suggesting advice from employer-sponsored advisors may not be trustworthy).

by this proposed legislation.[83] The fact that the advisors disclose their conflicts of interest will prove ineffective because they are essentially the only game in town. If the only advice available is conflicted advice, participants will either take that conflicted advice or be no better off than they are now. Moreover, plan participants are likely to view a service provider selected by the employer to provide investment advice as carrying an employer imprimatur (again, the operation of Professor Benarzti's endorsement effect) meaning that the advice is likely to carry great weight.

III. LIMITS OF ERISA FIDUCIARY STANDARDS

It is important to understand that the law will not force participants to make wise plan investment decisions, nor will it protect them from the consequences of their over-investment in employer securities.

ERISA does impose some limits on acquisitions of employer securities by pension plans. ERISA limits the acquisition of employer securities by defined benefit plans and by employer-directed defined contribution plans to up to 10% of the plans' assets.[84] However, no similar limits apply to acquisitions of employer securities by participant-directed plans, reflecting Congress' determination to protect employees only from employer opportunism rather than from themselves. Since about 65% of 401(k) plans, accounting for 73% of all participants, provide for participant direction,[85] the statutory limitations are not very meaningful in the current pension plan environment.

That situation is unlikely to change. Senators Boxer and Corzine introduced legislation on December 18, 2001 that proposed to limit the amount of employer securities that may be invested in company stock. Under their proposal, no more than 20% of 401(k) investments could be in company stock. In addition, the proposed legislation would have limited the tax deduction for matches made in company stock in order to discourage the practice.[86] However, it became clear that neither a percentage limit nor a provision

83. The proposed legislation imposes on employers only a general obligation to monitor, not any obligation to monitor specific advice.

84. 29 U.S.C. § 1107(a)(2), (b)(2)(B)(ii) (2001). The limit on defined benefit plan acquisitions of company stock was part of ERISA as originally enacted. The limit on acquisitions by employer-directed defined contribution plans was added to the statute effective 1999. When the statute was enacted individual account plans were exempted from the 10% limit out of recognition for their "special purpose." Library of Congress, *ERISA: Selected Legislative History: 1974 - 1986* at 50-51 (1986).

85. U.S. GENERAL ACCOUNTING OFFICE, *401(k) Pension Plans: Extent of Plans' Investments in Employer Securities and Real Property* 9 (Nov. 1997).

86. S. 1838, 107th Cong. (Dec. 18, 2001). *See also* Oppel, Jr., *supra* note 16, at C1.

discouraging matching contributions in employer stock was politically viable.[87] As a result, Senators Corzine and Boxer withdrew their legislation in favor of Senator Kennedy's bill that contains no such limit.[88] The Pension Security Act of 2002, passed by the House on April 11, 2002, likewise contains no percentage limit on the acquisition of employer securities,[89] opting instead for a disclosure/education approach that I have already shown is doomed to fail.

The law also imposes no standards on participant decisions with respect to the investment of their plan contributions, meaning there are no external controls to counter participants' behavioral tendencies to over-invest in employer securities. Although exercising control over investment of pension plan assets is something that by statutory definition makes one a fiduciary,[90] and thus, subject to fiduciary standards of prudence and diversification,[91] this does not hold true for participants making 401(k) plan investment decisions. Section 404(c) of ERISA explicitly provides that participants who exercise control over the assets of their defined contribution plan accounts are not deemed to be fiduciaries by reason of such exercise[92] and that no person who is otherwise a fiduciary to the plan has liability for losses resulting from the participants' exercise of control.[93] Thus, ERISA's fiduciary standards of prudence and diversification do not operate here. Although heavy plan investments in a single security potentially violates both ERISA's prudence and diversification standards, the effect of section 404(c) is that no one is liable for what would clearly be a violation if we (consistent with the statutory definition) labeled the employee a fiduciary.

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87. Opposition to the idea of a cap came from many quarters. For a summary of arguments raised against capping investments in employer securities. see U.S. DEP'T OF TREASURY, *supra* note 14, at 4-7. Similar concerns doomed the proposal to limit the deduction for matches made in employer securities, most notable the fear that the proposal would discourage matching contributions.

88. *See* Press Conference, *supra* note 55 (endorsing Senator Kennedy's bill, Sen. Boxer stated "it hits on the issues that Sen. Corzine and I feel so strongly about, which really are diversification and divestment").

89. *See infra* note 6 (discussing legislation proposed by Congress).

90. 29 U.S.C. § 1002(21)(A)(i) (2000).

91. 29 U.S.C. § 1104(a) (2000).

92. 29 U.S.C. § 1104(c)(1) (2000). A participant exercises control over the assets in his or her individual account for purposes of Section 404 when he or she receives adequate information concerning investments, is given the opportunity to make independent investment decisions, and has access to a broad range of investment alternatives. 29 C.F.R. § 2550.404c-1 (2001).

93. 29 U.S.C. § 1104(c)(2) (2000). For a more complete discussion of Section 404(c) requirements and its impact on 401(k) plans see generally Stabile, *supra* note 34; JOINT COMMITTEE ON TAXATION, *Background Information Relating to the Investment of Retirement Plan Assets in Employer Stock,* Feb. 11, 2002, at 7-8.

Therefore, nothing prevents employees from heavily investing in employer securities. Many of those who have done so, are starting to feel the stings of a declining stock market, prompting them to seek relief from their employers. Indeed, several class action suits have been filed in the last year or so.[94] Let me say a few words about a couple of the lawsuits currently in progress.

Enron. Anyone who has read the newspaper recently is aware of the problems that have beset Enron Corporation and the effect of those problems on the account balances of the company's 401(k) plan participants, about 60% of which was invested in Enron stock.[95] It appears that during at least part of the time that the company's stock was plummeting, participants were prevented from moving their plan assets out of the company stock fund and into less risky alternatives. Enron's explanation for the freeze was that it was switching plan administrators and the shutdown was required to allow for an accurate transfer of employee account information, a fact that they gave employees notice of in advance.[96] According to newspaper reports, plan choices were frozen on October 17, 2001 when Enron stock was trading at $32.20 per share.[97] As the shares lost virtually all of their value, plan participants lost 70-90% of their retirement assets, and some participants saw their account balances fall by several hundred thousand dollars.[98] According to Enron, participants were prevented from switching out of company stock only from October 26 through November 12, 2001[99] during which time the stock went

94. *See* Christine Dugas, *Workers Sue Companies in 401(k) Disputes*, USA TODAY, Mar. 7, 2002, at 1B (noting recent filings of lawsuits against Providian Financial, Nortel Networks, and Global Crossing).

95. *See Gottesdiener Law Firm, supra* note 63 (referring to Gottsediener's statement that Enron had encouraged employees to "load-up" on company stock).

96. *See* Shannon Buggs, *Labor Dept. Examines Enron Retirement Plan*, THE HOUSTON CHRONICLE, Dec. 6, 2001, at A1 (noting employees received notice of the freeze, but no explanation about the over $1 billion charge attributed to Enron's investment partnerships). *See also* Judith Schoolman, *Enron Says 401k Freeze Was Planned,* DAILY NEWS (New York), Dec. 15, 2001, at 18 (writing about Enron 401(k) freeze).

97. *Retirement Plans: Post Enron 401(k) Strategies*, HRFOCUS, Mar. 2002, at 1. *See also Enron Debacle Will Force Clean Up of Company Stock Use in D.C. Plans*, D.C. PLAN INVESTING, Dec. 2001, at 1 (noting Enron's offer to match company stock accompanied a prohibition on conversion until participant reached the age of 50).

98. *See* Buggs, *supra* note 96, at A1 (noting employees received notice of the freeze, but no explanation about the over $1 billion charge attributed to Enron's investment partnerships). *See also Labor Opens ERISA Investigation of Enron Assistance to Dislocated Workers Also Begins Today*, U.S. NEWSWIRE, Dec. 5, 2001 (quoting Department of Labor Secretary Chao's statement: "Enron's employees have gotten the short end of the stick in the sudden collapse of this company").

99. *See* Stabile, *supra* note 5, at 2-6.

from $15.40 to $9.00.[100] Employees dispute Enron's characterization of the time period and say they were prevented from switching accounts for a longer period.[101]

The staggering losses have led to an investigation by the DOL into the steps the company took shortly before its collapse to prohibit employees from making transactions with their 401(k) plan assets. It has also led to class-action lawsuits on behalf of plan participants alleging that the company was promoting company stock and matching employee contributions with company stock at a time when it knew the stock was overvalued. The suit alleges that the company schemed to pump up the price of the stock artificially and violated its fiduciary duty to employees by failing to act in their best interests by, among other things, withholding from participants key information regarding the company's financial situation. The suit also alleges violations based on the suspension of plan trading during a critical period of plummeting Enron stock value, preventing employees from stemming their losses by switching out of the employer stock fund.

Lucent Technologies. During an 18-month period, from the end of 1999 to the middle of 2001, the stock of Lucent Technologies plummeted over 90%.[102] A large number of Lucent employees were heavily invested in the company's stock, resulting in significant plan losses.[103] (Some employees saw their account balances shrink by $200,000.)[104] A class-action suit filed at the end of July 2001 alleges that Lucent executives tried to persuade company employees to invest their plan assets in company stock, even though they knew the company was in serious financial trouble.[105]

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100. *See id.* at 2-7. *But see* Jay Hancock, *'Fixing' the 401(k) Could Make It Worse*, BALTIMORE SUN, Feb. 6, 2002, at 1C (noting although the decrease during the blackout period was substantial, it was "relatively minor" compared with the ultimate result).

101. *See* Hancock, *supra* note 100, at 1C (noting that Enron had a problem with accounting and honesty).

102. *See* James J. Choi, David Laibson, Brigitte C. Madrian, & Andrew Metrick, *Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance*, Nov. 9, 2001, at 28, *available at* http://post.economics.harvard.edu/faculty/ laibson/papers/plr.pdf

103. *See* Christine Williamson & Arleen Jacobius, *401(k) Participants Go to Court: Lucent Sued Over Company Stock Option*, PENSIONS AND INVESTMENTS, Aug. 20, 2001, at 1 (comparing the Lucent suit with First Union Corp. and AirTouch suits).

104. *See* Danny Hakim, *Former Workers at Lucent See Nest Eggs Vanish, Too*, N.Y. TIMES, Aug 29, 2001, at A1 (recounting personal losses by Lucent employees).

105. *See Lucent's 401(k) Crash*, PENSIONS AND INVESTMENTS, Sept. 3, 2001, at 10 (noting that Ikon Office Solutions employees have made similar allegations against their employer). Ikon's stock fell from $51.63 in early 1997 to $2.81 in October 2001. The Ikon lawsuit was recently settled. *See Ikon Settles ERISA Litigation*, *supra* note 56 (reporting on the Ikon settlement agreement).

The suit alleges that company executives knew the stock was an inappropriate plan investment since year-end 1999.

These will not be easy lawsuits for plaintiffs[106] for several reasons. First, plan design decisions, such as requiring that matches be made in employer securities, are not fiduciary decisions, but settlor decisions.[107] This means that an employer's decisions to offer an employer stock fund as an investment alternative and to match employee contributions in company stock are not subject to ERISA's fiduciary standards. Because such decisions are not fiduciary ones, they need not be made in the best interests of plan participants but may suit the company's business needs. Thus, the decision to require that a company match be made in employer securities is probably not one that can be challenged. So long as the requirements of 404(c) regarding investments in employer securities[108] and frequency of investment changes are met,[109] it will be difficult to argue that the plan sponsor acted inappropriately.

What about an allegation that a company should have ceased to permit employees to invest in company stock or that it should have refrained from continuing to match in company stock due to a downturn in the value of the company's stock? Plan fiduciaries do, after all, have an obligation to prudently select and to monitor a

106. One commentator characterized the plaintiffs' claims in these lawsuits as "fairly creative claims of violation of fiduciary duty." *See* Oppel Jr., *supra* note 16, at C1 (citing James Delaplane of the American Benefits Council).

107. *See generally*, Akers v. Palmer, 71 F.3d 226 (6th Cir. 1995); Malia v. Gen. Elec. Co., 23 F.3d 828 (3d Cir. 1994). By allowing a company and its officers and directors to act as fiduciaries, ERISA accepts that employers will act in a dual capacity, as both fiduciary to the plan and as employer. 29 U.S.C. § 1108(c)(3) (2000). Only when and to the extent that the employer functions in a fiduciary capacity are ERISA duties implicated. Other decisions an employer makes are viewed to be employer, or "settlor" decisions, not subject to ERISA. "[T]he mere fact that a company has named itself as pension plan administrator or trustee does not restrict it from pursuing reasonable business behavior in negotiations concerning pension benefits not otherwise affected by the requirements of ERISA." United Indep. Flight Officers, Inc. v. United Air Lines, Inc., 756 F.2d 1262, 1268-69 (7th Cir. 1985). ERISA is not intended to "prohibit an employer from acting in accordance with its interests as an employer when not administering the plan or investing its assets." Hlinka v. Bethlehem Steel Corp., 863 F.2d 279, 285 (3d Cir. 1988) (quoting Hickman v. Tosco Corp., 840 F.2d 563 (8th Cir. 1988)).

108. Section 404(c) specifically contemplates that a 401(k) plan may include an employer stock fund as an investment option so long as certain conditions are met. These conditions include requirements that the securities are qualifying employer securities as defined in ERISA, that they be publicly traded and traded with sufficient frequency and in sufficient volume to assure that participant directions to buy and sell shares can be executed promptly, that participants receive all information provided to other shareholders of the company, and that voting, tender and similar rights be passed through to participants. 29 C.F.R § 2550.404C-1(d)(2)(i)(E)(4)(iii-vi)(2001).

109. 29 C.F.R. § 2550.404C-1(b)(2)(vi) (2001).

401(k)'s plan investment options.[110] Nonetheless, these claims are also unlikely to succeed.

A fiduciary's duty to monitor 401(k) plan investment options may mean, for example, that a fiduciary has an obligation to change from one growth mutual fund to another growth mutual fund that appears to have better long-term prospects, or a duty to secure a new guaranteed investment contract that provides more favorable terms to plan participants than an existing one. It is difficult, however, to translate that duty into an obligation to remove a company stock fund in the face of declining stock value. The fact that stock values fluctuate all of the time, combined with the fact that 401(k) plans generally have fairly long-term horizons, means that the plan sponsor should be justified in continuing to make available a company stock investment option unless the fiduciary has information leading it to reasonably believe the company has no future prospects.[111] Thus, in most cases, a decision to retain an employer securities stock fund is likely to be viewed as consistent with ERISA's fiduciary standards.

In addition, regardless of the standard applied to the employer's decision to continue to allow an employer stock fund, participants in most cases are free to switch at least their own contributions in and out of an employer stock fund virtually at will.[112] That means that the cause of any plan account loss will be viewed to be the participant's failure to move the stock to a different, less risky alternative. Most employers will be able to show that employees were warned of the dangers of lack of diversification and were told that employers were not providing them with investment advice. Short of being able to demonstrate actual misrepresentation on the part of plan fiduciaries acting in a fiduciary capacity,[113] plaintiffs will not have an easy time in these

110. The DOL's § 404(c) regulations make clear that compliance with the regulations shields the employer from liability for losses caused by the participants' exercise of control over their plan accounts, but that the employer is not relieved from its duty of prudence. 29 C.F.R § 2550.404C-1(b)(2)(i) (2001).

111. Such situations may arise and may cause a prudent fiduciary to cease offering a company stock fund. For example, Federal Mogul, an auto parts maker, ceased offering a company stock fund in its 401(k) plan in July 2001, due to a sharp decline in the price of the company's shares resulting from concerns about potential asbestos liability. In October, the company filed for bankruptcy. *See* Oppel Jr., *supra* note 16, at C1.

112. *See* Purcell, *supra* note 11, at 3. (noting that in the case of Enron, approximately 89% of the plan's investment in company stock was attributable to participants' own contributions and 10% to the company match).

113. *See* Varity Corp. v. Howe, 516 U.S. 489, 498-505 (1996) (noting that misrepresentations by plan sponsor acting in a fiduciary capacity violate ERISA's fiduciary duties). "*Varity* suggested that statements about a company's financial future generally will not be viewed as fiduciary ones. However, *Varity* did not focus on a plan in which employees were investing in

suits.

I emphasize communications from fiduciaries acting in a fiduciary capacity because 10b-5 type allegations that the company made false and misleading public statements are not going to give rise to a viable ERISA suit.[114] Allegations have been made, for example, that Enron Chairman Kenneth Lay "urged his employees to scoop up the company's stock at what he called 'bargain' prices even as he sold many of his own shares."[115] It remains to be seen whether a court will decide that such statements were made in a fiduciary capacity and therefore give rise to ERISA liability.

What about the decision of a plan fiduciary to continue to match in company stock, in accord with the terms of a plan? In *In re Ikon Office Solutions Securities Litigation*,[116] a federal district court refused to grant a defendants' motion to dismiss based on their claim that they could not be held liable for requiring or continuing to require that matching contributions be invested only in employer stock. Citing the "presumption" language of the Third Circuit's decision in *Moench v. Robertson*,[117] the court said that even though the plaintiff bore a heavy burden, the plaintiff must

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company stock. Thus, under the reasoning in *Varity*, it would not be surprising for a court to find that statements about a company's future prospectus, if they are made in the context of discussions about the company's benefit plans and by persons whom employees would perceive to be acting in the capacity of plan administrator as well as employer, may be viewed as subject to ERISA's fiduciary standards." Stabile, *supra* note 5, at 6-4.

114. Even if a communication is viewed as being benefits-related, it still must be ascertained whether the person making it is a fiduciary. Although the strictest view would be that there can be no violation of ERISA's fiduciary standards where the communications in question were made by persons who were not plan fiduciaries, some courts have applied an apparent-authority principle, suggesting that if statements are made by persons who, because of their position and duties, participants might reasonably be expected to rely, there can be a fiduciary breach. *See generally* Bowerman v. Wal-Mart Stores, Inc., 226 F.3d 574, 590 (7th Cir. 2000); Taylor v. Peoples Natural Gas Co., 49 F.3d 982, 988-89 (3d Cir. 1995). Sometimes courts are even more lenient, finding fiduciary liability based on statements by "management personnel" or simply the "employer." Examples can be found in *Drennan v. Gen. Motors Corp.*, 977 F.2d 246, 249-52 (6th Cir. 1992) which found "management personnel" statements regarding a window plan to be fiduciary acts. Likewise, the court in *Ballone v. Eastman Kodak Co.*, 109 F.3d. 117 (2d Cir. 1997) found liability based on "employer" statements, without identifying who was speaking as fiduciary. *Id.* at 124-25.

115. *See* Patrice Hill, *Targets Problems Exposed by Enron Employees' Losses*, WASH. TIMES, Apr. 12, 2002, at A3 (noting that Enron Chairman Kenneth Lay urged his employees to invest in the company's stock even though he sold many of his shares). *See also* John J. Sweeney, *Enron: Big Lies, Big Scandal,* PROVIDENCE JOURNAL-BULLETIN, May 14, 2002 (noting that as late as October, 2001 Lay assured employees that the company was in good shape and had no plans for any significant employee lay-offs).

116. 191 F.R.D. 457, 462 (E.D. Pa. 2000).

117 62 F. 3d 553 (3rd Cir. 1995)

have the opportunity to overcome the presumption that fiduciaries acted properly in continuing to match in company stock. In *Moench*, the court suggested that ESOP fiduciaries are "entitled to a presumption that [they] acted consistently with ERISA" standards when they invest in company stock.[118] It is not easy to overcome that presumption, and, in the ESOP context, courts have not been quick to hold fiduciaries liable for failing to sell employer stock that has drastically fallen in value.[119] The *Ikon* decision suggests that courts will examine a 401(k) plan fiduciary's decision to continue to invest matching contributions in company stock the same way the decision of an ESOP trustee is analyzed.

Thus, the law does very little to protect plan participants from the consequences of their decisions to continue to invest in employer securities.[120]

CONCLUSION

401(k) plans have replaced defined benefit plans as the primary means through which employers provide retirement benefits to their employees. While many praise this shift as a positive response to the needs and desires of an increasingly mobile work force, different risks have been created. These include low participation and contribution rates and the failure by many employees to leave funds in 401(k) plans when they change jobs.[121]

Over-investment in employer securities represents another significant problem with 401(k) plans. Given the freedom to do so, participants invest disproportionately in the stock of their employers. They do so because of various behavioral tendencies that are not susceptible to change through increased education efforts. Not only can they not be counted on their own to make sound investment decisions, but the law does nothing to force them to do so. We have thus created the risk that large numbers of employees will retire with account balances that will provide them with insufficient savings to support them during their retirement. Congress seems intent on preserving individual freedom to invest in employer securities with no limits, even at such a dangerous cost.

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118. *Id.* at 571.

119. *See* Kuper v. Iovenko, 66 F.3d 1447, 1459-60 (6th Cir. 1995) (noting that the Sixth Circuit found no ERISA violation where a fiduciary failed to sell stock that had drastically fallen in value).

120. The specific Enron situation presents a different situation. A decision by the plan fiduciary charged with administering the plan to freeze movements in and out of the employer stock fund is judged under a heightened standard. However, whether there is a winnable lawsuit here is open to question. Stabile, *supra* note 5, at 7-6, 7-8.

121. I discuss these problems in Stabile, *supra* note 35.