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PSLRA, SLUSA, and Variable Annuities: Overlooked Side Effects of a Potent Legislative Medicine

by Michael J. Borden*

INTRODUCTION

This Article highlights a harmful and far-reaching unintended consequence of two major pieces of securities litigation reform legislation¹ that were passed as part of the Republican party's Contract with America in the mid-1990s. These reforms were justified, in part, on the grounds that they would benefit investors by improving disclosure of financial information by corporations. However, for many aggrieved investors, the effect of the legislation was just the opposite. Because of inadequate and misleading disclosures made by life insurance companies and their registered representatives, consumers were induced to purchase inappropriate investments carrying excessive fees that reduced the value of their retirement nest eggs. Had the purveyors of these variable annuities adequately disclosed the nature of the product and fully explained the complicated factors that go into a decision to purchase a variable annuity, most consumers would not have purchased

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1. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified as amended in scattered sections of 15 U.S.C.); Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-69, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.).

variable annuities with tax-deferred moneys from their Individual Retirement Accounts ("IRAs") and 401(k)s.

As a result of these misleading sales practices, tens to hundreds of millions of dollars that ought to have provided retirement security to average Americans have instead been counted as profits by life insurance companies or commissions by their agents. To make matters worse, once the fraudulent nature of these transactions was brought to the attention of investors by the Securities and Exchange Commission ("SEC"), the National Association of Securities Dealers ("NASD"), the news media, and plaintiffs' attorneys, the investors found themselves barred from pursuing a judicial remedy by the business friendly provisions of the Securities Litigation Uniform Standards Act ("Uniform Standards Act" or "SLUSA")² and the Private Securities Litigation Reform Act of 1995 ("Reform Act" or "PSLRA")³—the very acts that were meant to enhance corporate disclosure to benefit investors.

Throughout the mid- and late-twentieth century, large companies compensated their employees with more than cash remuneration by providing a variety of benefits. Employees enjoyed benefits such as health and life insurance, discounts on products sold by their employer and its affiliates or partners, day care for their children, company cars, subsidized meals, paid vacation and sick days, and pensions.

Two recent trends have resulted in a significant decrease in the prevalence of these benefits. First, fewer Americans are spending their entire careers working for the large corporations that have historically provided these types of benefits. Second, the companies themselves are offering less generous perquisites. Specifically, the kinds of pensions that were once a mainstay of the typical long-term corporate employment arrangement are no longer available to the average worker. While fixed benefit retirement plans were the norm for decades, today's workers no longer have the luxury of such dependable sources of retirement income. The government has stepped in and attempted to fill the gap with IRAs, 401(k)s, 403(b)s, and other tax-deferred qualified plans. What the government has not done, and cannot do, is provide the expertise that corporate pension administrators have long wielded for the benefit of employees. As a result, individuals in the last twenty to thirty years have shouldered the responsibility of planning for their own retirements through management of their savings accounts and the

2. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified as amended in scattered sections of 15 U.S.C.).

3. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-69, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.).

purchase of investment instruments with moneys from various sources, including IRAs and 401(k)s.

But mom and pop investors are not usually qualified to navigate the shark-infested waters of the investment industry. The well-to-do typically have employed stock brokers, experts in the field upon whom the law imposes a fiduciary duty vis-à-vis the client. Stock brokers, however, have traditionally been an accessory of the affluent. Who advises the less well off? A breed of investment professionals known as financial advisors has come forward to serve the broad segment of the public whose account balances are too meager to appeal to white-shoe brokers. The aggressive sales practices of investment advisors and the companies they represent have caused many middle class investors to make ill-advised purchases of products that carry excessive fees.

Licensed and regulated by the states, investment advisors are sometimes employed by large insurance or financial services companies, and are sometimes independent, like insurance agents. In fact, frequently they are also insurance agents. Middle-class Americans, with modest amounts of money to invest, sometimes encounter investment advisors in the small offices or shop fronts conveniently located in shopping centers and malls. A degree of legitimacy is conferred by the familiar brand names under which these advisors operate: American Express Financial Planners and Nationwide Financial Advisors, for example. The consumer's familiarity with the investment company's brand name frequently engenders a sense of confidence and trust that is not always well placed.

A recent example of the dangers of such encounters provides a cautionary tale about the vulnerability of today's middle class investors seeking to provide themselves the kind of financial security in retirement that a career at IBM or Ford Motor Corporation once offered. The confluence of profit-motivated companies, their commission-driven sales people, and unsophisticated investors has produced a financial windfall for the companies and their agents. It has also cost their clients substantial sums of money and produced a great deal of litigation in recent years.

Variable annuities are a hybrid security and life insurance product that offer investors the appealing combination of tax-deferred investment growth and a guaranteed lifetime income. The importance of these benefits cannot be underestimated. As all but the wealthiest individuals know, when retirement age approaches and one contemplates terminating all earned income and relying solely on investment income, one fears that one's assets will not be sufficient to generate enough income for life. The worst scenario is to be old and infirm, with rising medical expenses and a dwindling nest egg. These concerns tend to induce aging

individuals to work longer and to trim their spending in an effort to allay their fears of asset depletion. Such concerns also induce forward-looking workers to seek ways to maximize their retirement savings.

The benefits of variable annuities are manifest and appealing, but they come at a price. The sales commissions, fees, and charges associated with annuities are higher than for other insurance and investment products. Obviously, salesmen who work mainly for commissions will want to sell the products from which they derive the most money. This is where the trouble begins. Because both the advisors, at the point of sale, and the insurance companies, whose products they sell, make high margins on the sales of annuities, salesmen exert a great deal of pressure on consumers to buy them. In addition to pressure from the companies, the advisors have their own private incentives to increase their sales of annuities.

If annuities are such great retirement vehicles, then what is the problem with investors buying them in great quantity? The problem is that unsophisticated individuals of modest wealth do not frequently have \$100,000 lying idle in their savings accounts. However, they often do have substantial sums amassed in their IRAs and 401(k)s. So with vigorous encouragement from sales agents, they purchase the annuities with the money in those tax-qualified plans and get the tax-deferred investment and the guaranteed lifetime income. If this strikes you as troublesome, then you are in good company. You are in the company of plaintiffs' lawyers, knowledgeable investors, regulators, and the executives and investment advisors working for the companies who sell annuities. If nothing seems amiss, then you are also in excellent company with the millions of consumers who have purchased expensive deferred annuities with moneys from their qualified plans.

The problem is that when investors buy variable annuities using funds from tax qualified plans, they are buying something they already have by operation of law—tax deferral—and they are paying dearly for it. The investor realizes no incremental benefit from the second dose of tax deferral. This belt-and-suspenders approach to sales of annuities earned hundreds of millions of dollars in revenues for the insurance industry and eventually generated huge fees for lawyers representing both plaintiffs and defendants in ensuing litigation. Beginning in 1998, plaintiffs' firms sued several leading life insurance companies, alleging that the sales of variable annuities into qualified plans amounted to fraud, deceptive trade practices, negligent misrepresentation, and breach of fiduciary duty. In 2000 the federal courts of appeals began dismissing these cases on the grounds that the claims were preempted by the Uniform Standards Act.

Part I of this Article explains the text and legislative history of the Reform Act of 1995 and the Uniform Standards Act of 1998. Specifically, Part I highlights the lack of attention with which the crucial definition of “covered security” in the 1998 law was drafted.⁴ Part II explains the investment instrument known as the variable annuity and its fundamental inappropriateness as an investment for many purchasers, namely those buying a variable annuity to place into a tax-qualified plan such as an IRA or 401(k). Part III describes changes in the ways Americans and their employers provide for retirement security. Part III also demonstrates that because of those changes, purchasers of annuities have suffered important financial harms that should not go unremedied. Part IV explains how this problem was addressed on multiple fronts by various institutions. Part IV further shows how the Reform Act and the Uniform Standards Act operated to decapitate a judicial process that seemed to be leading toward a resolution of the problem. Part V reveals the upshot of the legislative preemption of the annuities cases and provides some statistics indicating that any disciplinary effect that would have been accomplished by the responses outlined in Part IV has been totally undercut by the inability of plaintiffs to gain meaningful access to the courts.

I. THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 AND THE SECURITIES LITIGATION UNIFORM STANDARDS ACT OF 1998

A. *The Private Securities Litigation Reform Act of 1995*

In 1995, after achieving substantial electoral gains and eager to implement the Contract with America, the Republican Congress followed through on a promise to enact meaningful tort reform by changing the way economic torts are litigated.⁵ On December 22, 1995, Congress enacted, over a presidential veto, a major piece of securities litigation reform legislation.⁶ The Reform Act was promoted as a means of protecting the high-tech industry from abusive securities fraud class actions in the federal courts.⁷ Aimed at reducing frivolous strike suits,⁸

4. Uniform Standards Act, Pub. L. No. 105-353, 83 State. 3227, 3230 (1998).

5. See Edmund L. Andrews, *Republicans Agree to Soften A Bill to Curb Investor Suits*, N.Y. TIMES, Feb. 11, 1995, at A1.

6. Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (1995).

7. Many of the witnesses invited to testify at hearings on the Reform Act were executives at or financiers of high technology companies, or representatives of high-tech industry associations. See, e.g., *Securities Litigation Reform Proposals: Hearings on S. 240, S. 667, and H.R. 1058, Before the Subcomm. on Securities, Senate Comm. on Banking, Housing, and Urban Affairs*, 104th Cong. 21 (1995) (Statement of George H. Sollman,

the Reform Act changed the securities laws in three significant ways. First, its heightened pleading provisions required plaintiffs to plead with particularity the facts that support a claim of fraud.⁹ Second, it imposed a mandatory stay of discovery in securities class actions while a motion to dismiss is pending.¹⁰ Third, it provided a "safe harbor" for forward-looking statements made by issuers.¹¹ This safe harbor provision was intended to encourage corporate executives to speak more freely about their company, its products, and its financial prospects, by limiting plaintiffs' ability to sue on the basis of those projections.¹²

The heightened pleading rules and the discovery stay, when taken together, represent a powerful procedural shield for defendants. In the earliest stages of litigation, even before a complaint is filed, plaintiffs' attorneys often gather information in a catch-as-catch-can fashion: They collect snatches of information from whatever sources they can find, frequently relying on leaks originating from within potential defendant companies.¹³ Plaintiffs commonly base their pleadings upon "information and belief," and then flesh out their allegations with information amassed during discovery.¹⁴ The new pleading standards require

President and Chief Executive Officer, Centigram Communications Corp., on Behalf of the American Electronics Association) [hereinafter *Sollman Statement*] (explaining the "effect that abusive securities lawsuits are having on high-growth, high-tech companies"); See also *id.* at 36-39 (prepared Statement of Senator Pete V. Domenici) [hereinafter *Domenici Statement*] (asserting that a main victim of strike suits are the "high-growth, high-technology companies which are the backbone of our economy and the foundation of our ability to compete in the new global marketplace"). See Neil A. Lewis, *House Passes Bill That Would Limit Suits of Investors*, N.Y. TIMES, Mar. 9, 1995, at A1.

8. See REPORT OF THE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS OF THE UNITED STATES SENATE ON THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995, S. REP. NO. 104-98, at 8-12 (1995).

9. 15 U.S.C. § 78u-4(b) (2000).

10. 15 U.S.C. §§ 77z-1(b), 78u-4(b)(3)(B) (2000).

11. 15 U.S.C. §§ 77z-2, 78u-5 (2000).

12. S. REP. NO. 104-98, at 16.

13. See James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 520-21 (1997) (explaining the difficulty of obtaining evidence to support allegations before defendant's files are pried open by discovery).

14. *Id.* at 520. While Rule 9(b) of the Federal Rules of Civil Procedure already required plaintiffs to plead allegations of fraud with particularity, Congress was not satisfied with the rigor with which that rule had been interpreted. FED. R. CIV. P. 9(b). The Reform Act therefore requires that "the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b). See also JOINT EXPLANATORY STATEMENT OF THE COMM. OF CONF., STATEMENT OF MANAGERS—THE "PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995," H.R. CONF. REP. NO. 104-369, at 41 (1995) (explaining Congress's dissatisfaction with judicial enforcement of

plaintiffs to obtain specific facts prior to filing the complaint, while the discovery stay deprives them of the most powerful means of collecting such information.

The safe harbor for forward-looking statements also has important implications for the litigation process, cordoning off from judicial scrutiny certain communications that convey the issuer's beliefs about the future.¹⁵ Protected communications include statements containing projections of revenues, earnings per share, income, dividends, or other financial items; statements regarding management's objectives or plans for future operations; and statements describing the assumptions underlying management's assessments about the future.¹⁶ But this provision reflected more than a policy judgment about how litigation should be conducted; it had a much more ambitious and important goal. Enactment of the safe harbor provision was premised upon Congress's belief that such protections would enhance the efficiency of the capital markets by injecting more high-quality information into the mix of information relied upon by the market, in turn making investing less risky and decreasing the cost of raising capital.¹⁷ Corporate managers, no longer inhibited by fear of litigation, would disclose more information, and both issuers and investors would be better off.¹⁸

In extensive legislative hearings and deliberations leading to the passage of the Reform Act, Congress heard a great deal of testimony from securities industry leaders as well as many representatives of the high-technology sector.¹⁹ Fully aware that attempts to erect barriers to investor suits for damages would be politically unpopular, Congress sought to make the reform measures palatable by portraying them as an attempt to free a powerful engine of economic growth, the high-tech industry, from the drag of abusive securities litigation.²⁰ This strategy was opportunistic for two reasons. First, investing in technology

Rule 9(b)), reprinted in 1995 U.S.C.A.N. 730, 740.

15. 15 U.S.C. §§ 77z-2, 78u-5 (2000).

16. *Id.* §§ 77z-2, 78u-5.

17. See S. REP. NO. 104-98, at 5.

18. *Id.* at 16. The Senate report quoted one-time SEC Chairman Richard Breeden asserting that "[s]hareholders are also damaged due to the chilling effect of the current system on the robustness and candor of disclosure. Understanding a company's own assessment of its future potential would be among the most valuable information shareholders and potential investors could have about a firm." *Id.* at 15-16. The report continued, "[f]ear that inaccurate projections will trigger the filing of a securities fraud lawsuit has muzzled corporate management." *Id.* at 16.

19. See *Sollman Statement*, *supra* note 7; see also *Domenici Statement*, *supra* note 7.

20. S. REP. NO. 104-98, at 33 (pointing out that twenty-four of the forty largest member firms of the American Electronics Association had been sued for securities fraud and stating, "there seems to be a pattern of targeting high technology companies"). *Id.*

companies was on its way to becoming a national obsession. The stock market had begun to soar, especially the tech-heavy NASDAQ, and as long as their portfolios were rising, bullish investors were happy to free these new economy thoroughbreds from the yoke of excessive litigation. Second, because high-tech companies frequently experienced major fluctuations in stock prices, they were seen as a prime target for unscrupulous plaintiffs' lawyers bringing meritless class actions under the securities laws.²¹ With the exuberance generated by leaders of the new economy, Congress was able to portray these firms as Exhibit A for the need to substantially overhaul the way securities litigation was conducted. On December 22, 1995, Congress overrode President Clinton's veto of the Reform Act.²²

1. An Impatient Congress Assesses the Impact of the Reform Act. Having achieved this landmark reform, Congress might have been expected to sit back and admire its handiwork. Of particular importance to all observers was how the courts were going to interpret the heightened pleading requirements.²³ Specifically, confusion existed about whether the new law raised the scienter standard under section 10(b) of the 1934 Act to require a showing of intent to defraud, as opposed to the more easily met recklessness standard that had prevailed in many jurisdictions, including, most importantly, the Second Circuit.²⁴

Many litigators and academics kept a keen eye on the specifics of judicial interpretation of the Reform Act, while other, more easily comprehensible effects of the law became the focus of legislators.²⁵ The net reduction in the number of securities class actions filed seemed to be the touchstone for the industry leaders and congressmen who pushed hard for the passage of the Reform Act.²⁶ To the extent that the goal

21. *Id.* at 16. The Senate Report stated that "high-growth businesses—because of the volatility of their stock prices—are particularly vulnerable to securities fraud lawsuits when projections do not materialize." *Id.*

22. Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (1995).

23. Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1, 35 (1998).

24. President Clinton's message accompanying his veto of H.R. 1058 explained that he would have signed the bill had it contained (among other things) a provision adopting the Second Circuit Court of Appeals pleading requirements. VETO OF H.R. 1058, MESSAGE FROM THE PRESIDENT, H.R. DOC. NO. 104-150, at 1, 2 (1995).

25. See REPORT ON SECURITIES LITIGATION UNIFORM STANDARDS ACT OF 1998, H.R. REP. NO. 105-640, at 10 (1998).

26. See *The Securities Litigation Uniform Standards Act of 1997: Hearing on S. 1260 Before the Subcomm. on Securities, Senate Comm. on Banking, Housing, and Urban Affairs*, 105th Cong. 6 (1997) (opening statement of Representative Anna G. Eshoo) (citing statistics

of the Reform Act was to reduce the number of weak securities class actions filed while not unduly burdening meritorious ones, all were eager to appraise its effectiveness.²⁷ Simple tabulation of the filing, dismissing, and settling of securities class actions was one simple method of evaluating the success of the Reform Act. A second technique, more qualitative and cumbersome, would have been to examine all of the cases and assess their relative strength (both those that met the new pleading standards and those that were dismissed for failing to do so) as compared to those brought in the years preceding the passage of the Reform Act. The latter technique would have required years of research and analysis but would have painted a more nuanced and complete picture of the impact of the Reform Act.²⁸ Such findings would have helped Congress ascertain whether it had achieved the proper balance between promoting corporate efficiency and protecting investors from fraud. Moreover, additional time was needed to determine whether the safe harbor provision of the Reform Act produced the desired effect.

2. The Debate Over Preemption. Congress was not so patient. The dust kicked up by the Reform Act had scarcely begun to settle when, in 1996, less than one year after its enactment, additional reform proposals began to emerge.²⁹ By October 1997 nearly identical bills were introduced in both the House and Senate, aimed at responding to the perception that the goals of the Reform Act were being undermined by securities class actions brought in state courts.³⁰ The main purpose

on the number of securities class actions filed in state and federal courts) [hereinafter S. HRG. 105-420].

27. *Id.*

28. Indeed, this approach was advocated by a cadre of legal academics led by Professor Richard Painter. A letter signed by twenty-three securities law professors suggested that before moving forward with preemption legislation, Congress should make detailed findings on several questions: (i) Whether a significant number of suits will migrate from federal to state courts because of the 1995 Act; (ii) whether these suits have less merit than suits filed in federal court; (iii) whether state courts will allow plaintiffs to use parallel state court litigation to circumvent the new limitations on discovery in federal court; (iv) whether most states will continue the current trend toward conforming state law to the decidedly pro-defendant leanings of the federal law; and (v) whether state courts or legislatures will endorse efforts to create nationwide classes of plaintiffs in state court, and if so, whether the defendants in these suits will have significant contacts with the state in question. See 144 S. CONG. REC. S4784 (daily ed. May 13, 1998) (letter from Ian Ayres et al., Securities Law Professors, to Senators and Members of Congress (Jan. 23, 1998)).

29. Richard H. Walker et al., *The New Securities Class Action: Federal Obstacles, State Detours*, 39 ARIZ. L. REV. 641, 684 (describing early activity in the effort to pass preemption legislation).

30. House Bill 1689 was introduced by Anna Eshoo (D-Cal.) and Rick White (R-Wash.). See H.R. 1689, 105th Cong. (1997). Senate Bill 1260 was introduced by Phil Gramm (R-

of these bills was to preempt securities fraud class actions brought in state court under the legislative and common law of the states.³¹

Proponents of Senate Bill 1260 and House Bill 1689 explained the need for such a sweeping measure by explaining that the Reform Act left a "loophole."³² As one Senate cosponsor, Christopher Dodd, stated:

In general, I believe that the 1995 Reform Act . . . is working pretty well. In fact . . . it's working so well on the Federal level that weaker claims have migrated from Federal courts to State courts . . . a development that threatens . . . the success that we have achieved to date in this general area.

Moreover, without a national standard for liability, the potential threat is always there that one State will change its laws in such a way as to become the haven for litigation. This almost happened in California last year with Proposition 211. The potential remains it could successfully happen elsewhere in the future.³³

To support the view that the Reform Act left the job half done, the backers of the bills relied primarily on two sources: (1) data generated by Stanford Law School's Securities Class Action Clearinghouse,³⁴ and (2) a report by Stanford Professors Joseph A. Grundfest and Michael A. Perino.³⁵ The picture painted by these reports showed a world in which securities class actions had migrated from the federal courts to the state courts, particularly the California state courts.³⁶ The logic of this sequence of events seems self-evident—make it harder to sue in federal court and clever lawyers will sue in state court—and the reports seemed

Tex.), Christopher Dodd (D-Conn.), and Peter V. Domenici (R-N.M.) with ten cosponsors. See S. 1260, 105th Cong. (1997).

31. H.R. REP. NO. 105-640, at 9 ("The purpose of this title is to prevent plaintiffs from seeking to evade the protections that Federal law provides against abusive litigation by filing in [s]tate, rather than in [f]ederal court.").

32. See S. HRG. 105-420, *supra* note 26, at 2.

33. *Id.* at 15.

34. The Clearinghouse is an internet site launched in 1996 that amasses data about and filings from class action lawsuits. See *Securities Class Action Clearinghouse* at <http://securities.stanford.edu/> (Nov. 13, 2003).

35. See S. HRG. 105-420, *supra* note 26, at 66-81 (prepared Statement of Michael A. Perino) (explaining his findings and the findings of the Securities Class Action Clearinghouse and citing Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273, 302-14 (1998) (providing statistics showing an increase in state court class action filings in the wake of the Reform Act) and Joseph A. Grundfest and Michael A. Perino, *Securities Litigation Reform: The First Year's Experience* (John M. Olin Program in Law and Economics, Stanford Law School, Working Paper No. 140, Feb. 1997)).

36. See *id.* at 67-69.

to provide the data to prove it.³⁷ But as many commentators noted, the evidence was not as clear-cut as many lawmakers made it out to be.³⁸

The findings of these two reports were summarized in the Cornell Law Review by Professor Richard Painter, who concluded:

The statistical data, however, do not provide strong evidence of either a lasting substitution effect or a substantial increase in the number of parallel claims filed after 1995. The data compiled at Stanford Law School's Securities Class Action Clearinghouse, show that plaintiffs sued 110 companies in federal court in all of 1996, and eighty-three companies in the first six months of 1997 (an *increase* on an annual basis). . . . [The Grundfest-Perino study] reports that plaintiffs sued seventy companies in state court in all of 1996, and twenty-four companies in the first six months of 1997 (a *decrease* on an annual basis). The Stanford database does not include pre-1996 state court filings. Nonetheless, the Grundfest-Perino study compared the 1996 and 1997 figures with the number of filings before 1996 and "speculated that these figures represented an *increase* in state court filings, based on anecdotal reports that securities class action litigation was rarely filed in state court prior to the [1995] Reform Act." The speculative nature of this conclusion did not keep it from taking on a life of its own and eventually making its way into the Findings section of the Uniform Standards Act³⁹

Indeed, when Senate Bill 1260 was reported out of the conference committee, the House and Senate managers of the bill cited Grundfest and Perino's analysis in the House-Senate Conference Committee's Joint Explanatory Statement of the Committee of Conference:

"The evidence presented in this report suggests that the level of class action securities fraud litigation has declined by about a third in

37. *Id.*

38. See, e.g., Painter, *supra* note 23, at 42-46 (reviewing and explaining the findings of four major studies on the impact of the Reform Act). Professor Painter was a vocal opponent of the Uniform Standards Act and explained his opposition and his analysis of the data as a witness in hearings before the House and Senate. See also Eugene P. Caiola, Comment: *Retroactive Legislative History: Scierter Under the Securities Litigation Uniform Standards Act of 1998*, 64 ALB. L. REV. 309, 337-38 (2000) (noting the ambiguity of the evidence and its tendency to indicate that state court filings had decreased in 1997); Robin Generous, Note and Commentary: *Lander v. Hartford Life & Annuity Insurance Co.: Variable Annuities and the Future of Market Conduct Controls Post-SLUSA*, 8 CONN. INS. L.J. 505, 514 (2001-02) ("Studies prompting passage of SLUSA have also been criticized. Congress was presented with statistics showing an increase in state class actions . . . following adoption of PSLRA, suggesting a loophole to evade PSLRA requirements; however, other studies suggest that the increase was temporary and not directly related to PSLRA avoidance.").

39. Painter, *supra* note 23, at 42-43.

federal courts, but that there has been an almost equal increase in the level of state court activity, largely as a result of a 'substitution effect' whereby plaintiffs resort to state court to avoid the new, more stringent requirements of federal cases. There has also been an increase in parallel litigation between state and federal courts in an apparent effort to avoid the federal discovery stay or other provisions of the Act. This increase in state activity has the potential not only to undermine the intent of the Act, but to increase the overall cost of litigation to the extent that the Act encourages the filing of parallel claims."⁴⁰

The conference report continued:

Prior to the passage of the Reform Act, there was essentially no significant securities class action litigation brought in State court. In its Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995, the SEC called the shift of securities fraud cases from Federal to State court "potentially the most significant development in securities litigation" since passage of the Reform Act.⁴¹

Opponents of preemption brought to the debate data compiled by both the National Economics Research Associates, Inc. ("NERA")⁴²—an economics consulting firm—and a 1998 study by Price Waterhouse.⁴³ The data collected by NERA included the number of state court filings in 1994 and 1995, showing that state court filings went up after the passage of the Reform Act.⁴⁴ But NERA's data also included figures from 1997 showing that state court activity had substantially reverted to pre-1995 levels.⁴⁵ The Price Waterhouse study largely corroborated these conclusions.⁴⁶ These findings suggest that the evidence at hand during the preemption debate was incomplete and inconclusive.⁴⁷ All

40. H.R. CONF. REP. NO. 105-803, at 14 (1998) (quoting Grundfest & Perino, *supra* note 35).

41. *Id.*

42. See DENISE N. MARTIN ET AL., NAT'L ECON. RESEARCH ASSOC., RECENT TRENDS IV: WHAT EXPLAINS FILINGS AND SETTLEMENTS IN SHAREHOLDER CLASS ACTIONS? Iii, tbl. 10c (1996) [hereinafter 1996 NERA Study]; DENISE N. MARTIN ET AL., NAT'L ECON. RESEARCH ASSOC., FEDERAL SHAREHOLDER CLASS ACTION FILINGS RISE TO PRE-REFORM ACT LEVELS AS STATE FILINGS FALL 1-2, tbl. 2 (1997) [hereinafter 1997 NERA Study]; see also Painter, *supra* note 23, at 43-46 (analyzing and summarizing the findings of the NERA Studies as well as the entire body of empirical evidence considered by Congress).

43. See PRICE WATERHOUSE L.L.P., PRICE WATERHOUSE SECURITIES LITIGATION STUDY 1 (1998); see Painter, *supra* note 23, at 42-45.

44. See 1996 NERA Study, *supra* note 42, at 37, tbl. 4.

45. See 1997 NERA Study, *supra* note 42, at tbl. 1.

46. See Painter, *supra* note 23, at 43-44.

47. *Id.*

of this uncertainty was neatly encapsulated in the statement of Arthur Levitt, Chairman of the SEC: "I [do not] oppose reform, only reform that is too sweeping, and reform that is too hasty. [Let us] not replace the race to the courthouse with a race to the Capitol. It will take more time to gauge the effectiveness of the [1995 Reform] Act."⁴⁸ Furthermore, little evidence was available on the impact of the safe harbor provision of the Reform Act.

3. The Impact of the Safe Harbor Provision. Substantial theoretical and ideological emphasis is given to disclosure and transparency as a cure for many of the problems that plague the smooth functioning of the capital markets and the issuers and investors that rely on them.⁴⁹ Disclosure is also viewed as an important substitute for governmental regulation and oversight.⁵⁰ Indeed, a key animating principle behind the entire securities regulation regime is to encourage the production and dissemination of information in order to enhance the public's ability to invest in the capital markets. Rather than insisting on governmental command and control of the management of capital, the American system requires primarily that private actors disclose their actions.

The safe harbor provision of the Reform Act—an attempt to encourage disclosure—was therefore an important experiment aimed at improving the overall quality of information available to aid the public in making investment choices. But the ephemeral nature of disclosure, and its impact on investor decisionmaking, gives rise to difficulties in assessing the relationship between the two. Any evaluation of the overall success of the safe harbor was bound to require a great deal of time and a very sensitive analysis. The early evidence was tentative and conflicting. A Cornell Law Review article noted that a 1997 SEC staff report suggested that companies were not leaping to rely on the safe harbor but offered neither empirical data nor explanations.⁵¹ One possible explanation

48. *Securities Litigation Abuses, Hearing Before the Subcomm. on Securities, Senate Comm. on Banking, Housing, and Urban Affairs*, 105th Cong. 11 (1997) (opening statement of SEC Chairman Arthur Levitt) [hereinafter Opening Statement of Arthur Levitt].

49. See, e.g., *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 510 (7th Cir. 1989) ("The Securities and Exchange Commission believes that markets correctly value the securities of well-followed firms, so that new sales may rely on information that has been digested and expressed in the security's price.").

50. See Larry A. Ribstein, *Private Ordering and the Securities Laws: The Case of General Partnerships*, 42 CASE W. RES. L. REV. 1, 26-36 (suggesting the possibility of opting out of the federal securities laws where private ordering would be more efficient).

51. See Painter, *supra* note 23, at 46.

was that issuers were taking the rational step of waiting to see how the federal courts would interpret the Reform Act.

On the other hand, a 1998 study reported an “increase in both the frequency of firms issuing forecasts and the mean number of forecasts issued.”⁵² In fact, Wilson, Sonsini, Goodrich & Rosati, a leading advisor to Silicon Valley issuers, counseled its clients in early 1998 to rely on the safe harbor.⁵³ Those eager to pass additional reform legislation took the position that there would be little reliance on the safe harbor because the possibility of liability in state court suits effectively negated the existence of the safe harbor.⁵⁴ Without uniform standards in the state and federal courts, there really was no safe harbor.⁵⁵ Opponents of preemption legislation urged a wait-and-see approach.⁵⁶ Rather than waiting for a clearer picture to emerge, however, Congress seized the political moment and hurtled forward with the next stage of its reform initiative.

B. The Securities Litigation Uniform Standards Act of 1998

On November 3, 1998, Congress passed a companion to the Reform Act, the Securities Litigation Uniform Standards Act of 1998.⁵⁷ The purpose of the legislation was to “prevent plaintiffs from seeking to evade the protections that Federal law provides against abusive litigation by filing suit in State, rather than in Federal, court.”⁵⁸ To accomplish this aim, the Uniform Standards Act provides that:

[N]o covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or

52. Painter, *supra* note 23, at 46, 33 n.165 (quoting Marilyn Johnson et al., *The Impact of Securities Litigation Reform on the Disclosure of Forward-Looking Information by High Technology Firms* 23 (Jan. 2, 1998) (finding “that there was a significant post-1995 Reform Act increase in both the frequency of firms issuing forecasts and the mean number of forecasts issued”).

53. *Id.* at 46-47 n.259 (citing an article by Boris Feldman published on the Wilson Sonsini website stating that “[t]he safe harbor will go far toward eliminating the classic fraud-by-hindsight suit filed when a company fails to satisfy quarterly earnings expectations.”). See Boris Feldman, *Financial Fraud in the Era of Securities Reform*, at http://www.wsgr.com/resource/sec_lit/recent/finfraud.htm.

54. See 144 CONG. REC. E1390, E1391 (daily ed. July 22, 1998) (speech of Rep. Anna Eshoo) (“As long as the threat of state court actions remains, the safe harbor reform will never be implemented.”).

55. *Id.* at E1391.

56. See Opening Statement of Arthur Levitt, *supra* note 48, at 11.

57. Uniform Standards Act, Pub. L. No. 105-353, 112 Stat. 3227.

58. 144 CONG. REC. H11020 (daily ed. Oct. 15, 1998) (Joint Explanatory Statement of the Comm. of Conf.).

Federal court by any private party alleging . . . (1) an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security; or (2) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.⁵⁹

1. The Uniform Standard Act's Definition of Covered Security. Among the many legislators who believed there was a problem with securities class actions, the common understanding was that the Uniform Standards Act, in tandem with the Reform Act, was going to make it harder for plaintiffs' attorneys to harass publicly traded companies.⁶⁰ This understanding was reinforced by the frequent characterizations of "strike suits" as a rush to the courthouse to file a cookie cutter complaint every time a company's share price dropped ten percent on the NASDAQ or New York Stock Exchange.⁶¹ Throughout the congressional deliberations, backers of the Uniform Standards Act repeatedly stated that the purpose of the Act was to preempt state law claims of fraud in connection with the sale of nationally traded securities, especially securities issued by high-technology companies.⁶² This was the plain language understanding of all who considered the bill. But as we will see in Part IV-C, the ultimate definition of "covered securities" encompassed some kinds of investments that were not contemplated by the lawmakers.⁶³ Under the Uniform Standards Act, a "covered security" is one that meets the definition of "a covered security specified in paragraph (1) or (2) of section [18(b) of the Securities Act of 1933] at the time during which it is alleged that the misrepresentation, omission, or manipulative or deceptive conduct occurred"⁶⁴

It turns out that this two-pronged definition is an extremely broad one. Under section 18(b)(1), a covered security is one that is either

59. 15 U.S.C. § 77p(b) (2000).

60. See S. REP. NO. 104-98, at 8-12.

61. See S. HRG. 105-420, *supra* note 26, at 6, 7.

62. *Id.* at 2. For example, in his opening statement at the first Senate hearing on S. 1260, Senator Gramm said, "We have had many companies, especially new growth companies, plagued with abusive lawsuits, often being forced to settle out of court because of the high costs of proving innocence. We had a system of parasites who were literally bleeding the life blood out of growth companies in America."

63. As noted in *Lander v. Hartford Life Insurance Co.*, the voluminous legislative history of both the Reform Act and the Uniform Standards Act contains no reference to variable annuities. 251 F.3d 101, 110 (2nd Cir. 2001).

64. 15 U.S.C. § 77p(f)(3) (2000) (defining "covered securities" according to § 18(b) of the Securities Act of 1933, 15 U.S.C. § 77r(b), which was added to the Securities Act by NSMIA, Pub. L. No. 104-290, 110 Stat. 3417 (1996)).

"listed, or authorized for listing, on the New York Stock Exchange or the American Stock Exchange, or listed . . . on the Nasdaq Stock Market,"⁶⁵ or issued by "the same issuer that is equal in seniority or that is a senior security to" a security of the previous classification.⁶⁶ In plain English, this prong refers to the kinds of securities that anyone would recognize as a publicly traded security. Under the second prong of the definition, section 18(b)(2), a security is a covered security "if such security is a security issued by an investment company that is registered, or that has filed a registration statement, under the Investment Company Act of 1940."⁶⁷ By contrast, this second class of covered securities is not necessarily what leaps to mind when one envisions the kind of securities that are the targets of strike suits. In fact, this class was characterized, rather imprecisely, in the legislative history as referring to mutual funds.⁶⁸ But, to the substantial detriment of millions of Americans who have invested in variable annuities, it turned out to cover more than just mutual funds.⁶⁹ We will return to this last category of covered securities and to the aggrieved investors with greater attention later.

The Uniform Standards Act progressed through the House and Senate in the form of House Bill 1689⁷⁰ and Senate Bill 1260.⁷¹ As mentioned, the goal of these two bills was "to make Federal court the exclusive venue for most securities fraud class action litigation involving nationally traded securities."⁷² Although the two bills were almost completely identical, they contained small but important differences. One of these differences related to the number of plaintiffs required to constitute a "covered class action."⁷³ But the most significant difference between the two final versions of the Uniform Standards Act concerned the aforementioned definition of "covered security."⁷⁴

65. Pub. L. No. 104-290 §102 (b)(1)(A), 110 Stat. at 3418 (1996).

66. *Id.* § 102(b)(1)(C). Under this part of the definition, suits alleging fraud in connection with the purchase or sale of high yield (junk) bonds are not preempted because they are of lower seniority than the issuer's other outstanding securities.

67. *Id.* § 102(b)(2).

68. See Prepared Statement of Arthur Levitt, *infra* note 79.

69. See *infra* Part IV-C.

70. H.R. 1689, 105th Cong. (1997).

71. S. 1260, 105th Cong. (1997).

72. 144 CONG. REC. H11021.

73. The House bill initially defined "covered class action" as "any single lawsuit, or any group of lawsuits filed in or pending in the same court involving common questions of law or fact, in which . . . damages are sought on behalf of more than 25 persons." H.R. 1689, § 16(d)(1). The Senate bill defined the term as those actions in which "damages are sought on behalf of more than 50 persons or prospective class members . . ." S. 1260, § 16(f)(2). The final bill adopted the Senate's definition.

74. See H.R. 1689, § 16(d)(2); S. 1260, § 16(f)(3).

The House version, as introduced, provided that a security was a covered security “if the issuer of the security had outstanding any security that satisfied the standard for a covered security specified in Section 18(b)(1) of [the Securities Act] at any time during which it is alleged that the misrepresentation, omission, or manipulative or deceptive conduct occurred.”⁷⁵ This definition was broad in the sense that it classified covered securities based on whether the issuer had any listed securities, whether or not the security in question was actually traded publicly on any major national exchange.

When Senate Bill 1260 was introduced, it used a definition that was narrower in one sense, yet broader in another crucial sense. It provided that a security is a “covered security” if it “satisfies the standards for a covered security specified in paragraph (1) or (2) of Section 18(b) [of the Securities Act].”⁷⁶ Under this definition, the focus was on the character of the security itself, not on whether the issuer had other publicly traded securities. This focus limited the scope of the definition. However, the distinction that makes a difference in this Article was the inclusion of section 18(b)(2) covered securities (those casually referred to in the legislative history as mutual funds).⁷⁷ As a result of the incorporation of section 18(b)(2) in the definition of covered securities, any issuer required to register its securities under the Investment Company Act of 1940⁷⁸ gained the protections of the Uniform Standards Act. We will see in Part IV-C that this definition turned out to include variable annuities, a complicated but extremely widely held investment vehicle.

2. Overbreadth and Oversight in the Definition of Covered Securities. A fair amount of legislative attention was given to the scope of the preemption effectuated by the Uniform Standards Act, but little was said about the decision to include or exclude the section 18(b)(2) prong of the definition.⁷⁹ Rather, the legislators and witnesses

75. H.R. 1689, § 16(d)(2) (emphasis added).

76. S. 1260, § 16(f)(3).

77. See Prepared Statement of Arthur Levitt, *infra* note 79.

78. Investment Company Act of 1940, 15 U.S.C. § 80(a)-51 (2000).

79. The Prepared Statement of Arthur Levitt, Chairman of the Securities and Exchange Commission, seems to have been the catalyst for the ultimate decision to include the Section 18(b)(2) prong of the definition of covered security. In conclusory fashion, Levitt stated that “[s]hares of closed-end investment companies are deemed covered securities under H.R. 1689 because they trade over national exchanges. There is no reason why the definition should not be extended to also reach open-end investment companies.” Securities Litigation Uniform Standards Act of 1997, *Hearing on H.R. 1689 Before the Subcomm. on Finance and Hazardous Materials, H.R. Comm. on Commerce*, 105th Cong. 23 (1998) (prepared statement of Arthur Levitt, Chairman of the Securities and Exchange Commission) [hereinafter Prepared Statement of Arthur Levitt].

focused on two major problems with the definition. First, in testimony during legislative hearings, Professor Jack Coffee argued that the definition was defective because it was categorical.⁸⁰ Professor Coffee pointed out that debt instruments usually contain negotiated covenants and other provisions that are drafted to permit bondholders to sue over false statements in offering documents under more lenient standards of proof than those required in a federal common law action for fraud or by the scienter requirement associated with 10b-5 actions.⁸¹ A bill that insulated such agreements from judicial enforcement would eviscerate those private arrangements that are negotiated in detail at great cost, thereby depriving bondholders of the benefit of their bargained-for agreement.⁸² Common sense prevailed and Congress included in the Uniform Standards Act an exception from preemption for any class action "that seeks to enforce a contractual agreement between an issuer and an indenture trustee."⁸³

Another concession was extracted by those who urged that preemption should not extend to actions brought by a "State or political subdivision thereof or a State pension plan . . . on its own behalf, or as a member of a class comprised solely of [similar entities]."⁸⁴ The need for this carve-out was explained in testimony offered by representatives of the Government Finance Officers Association and the National League of Cities.⁸⁵ These witnesses argued that public pension funds needed to retain access to state courts to protect the enormous sums invested on behalf of millions of public employees.⁸⁶ With over \$2.2 trillion invested on behalf of 16.5 million members, these organizations

80. *Id.* at 61 (statement of Professor Jack Coffee) [hereinafter Statement of Jack Coffee].

81. *Id.*; Painter, *supra* note 23, at 54.

82. Statement of Jack Coffee, *supra* note 80, at 61; Painter, *supra* note 23, at 54.

83. H.R. 1689, 105th Cong. §§ 101(a)(1), 101(b)(1)(B) (1998), *reprinted in* 144 CONG. REC. H6053 (daily ed. July 21, 1998) (amending Securities Act of 1933 section 16(d)(3) and adding subsection (f) to section 28 of the Securities Exchange Act of 1934).

84. *Id.* § 101(a)(2) (1998), *reprinted in* 144 CONG. REC. H6053 (daily ed. July 21, 1998) (amending section 27(b) of the 1933 Act and section 21D(b)(3) of the 1934 Act).

85. S. HRG. 105-420, *supra* note 26, at 56 (prepared statement of Harry Smith, Mayor, City of Greenwood, Mississippi, on behalf of the National League of Cities) [hereinafter Prepared Statement of Harry Smith]; *The Securities Litigation Uniform Standards Act of 1997, Hearing on S. 1260 Before the Subcomm. on Securities, Senate Comm. on Banking, Housing, and Urban Affairs*, 105th Cong. 51 (1998) (prepared statement of J. Harry Weatherly, Jr., Director of Finance, Mecklenburg County, North Carolina, on behalf of the Government Finance Officers Association) [hereinafter Prepared Statement of J. Harry Weatherly, Jr.].

86. Prepared Statement of Harry Smith, *supra* note 85, at 56.

persuaded Congress to exempt state and local governments, and their pension funds, from the preemption legislation.⁸⁷

In these instances, the input of witnesses animated useful debate that improved the Uniform Standards Act by limiting the scope of preemption. But apart from a conclusory comment from Arthur Levitt generally endorsing the appropriateness of including all mutual funds in the definition of covered security,⁸⁸ scant attention seems to have been paid to the decision to preempt actions alleging fraud in connection with the purchase or sale of securities issued by investment companies. By the time the two bills were sent to the conference committee, the difference over whether the definition of covered securities should include section 18(b)(2) securities remained unresolved. However, when the compromise bill was introduced it included 18(b)(2) securities in the definition of covered securities.⁸⁹ The conference report offered little insight into the committee's decision to adopt the Senate bill's version including the section 18(b)(2) prong of the definition.⁹⁰ Referencing another securities reform initiative, the National Securities Markets Improvement Act of 1996 (NSMIA),⁹¹ the report noted that:

consistent with the determination that Congress made in the National Securities Markets Improvement Act (NSMIA), this legislation establishes uniform national rules for securities class action litigation involving our national capital markets. Under the legislation, class actions relating to a "covered security" (as defined by section 18(b) of the Securities Act of 1933, which was added to that Act by NSMIA) alleging fraud or manipulation must be maintained pursuant to the provisions of Federal securities law, in Federal court (subject to certain exceptions).⁹²

To what can we ascribe the dearth of legislative comment on the section 18(b)(2) component of the definition? Perhaps it is that mutual fund companies registered under the Investment Company Act were

87. Prepared Statement of J. Harry Weatherly Jr., *supra* note 85, at 51.

88. See Prepared Statement of Arthur Levitt, *supra* note 79, at 24.

89. H.R. CONF. REP. 105-803, at 4 (1998).

90. *Id.*

91. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3417 (codified as amended in scattered sections of 15 U.S.C.). NSMIA was passed to reduce the duplicative regulatory requirements caused by concurrent federal and state securities laws. NSMIA provides that any state law requiring regulation or qualification of "covered securities" is preempted by federal law. *Id.* The legislative history of NSMIA sheds no light on the policy considerations or political motivations that informed the drafting of the definition of covered securities in the Uniform Standards Act.

92. See H.R. CONF. REP. No. 105-803, reprinted in 144 CONG. REC. H10774 (daily ed. Oct. 13, 1998).

never a target of strike suits and thus were not present in the consciousness of the members of Congress. Yet given the radical nature of the Reform Act's undertaking and the haste with which Congress raced to pass the Uniform Standards Act, it seems as though lawmakers were in no mood for minimalism or incremental steps. With no real substantive debate over the need to preempt suits against mutual funds, the prevailing mindset boiled down to a belief that more preemption was better.

Despite the utterly transformative cumulative effect of these two major acts, the legislative history of the Uniform Standards Act is replete with proclamations that the Act represented a "targeted and narrow" measure.⁹³ Understanding the meaning of such statements is difficult when the direct effect of the Act was to bar the doors of state and federal courthouses to practically all victims of securities fraud seeking to vindicate their claims through class actions based on state law. When viewed in tandem with the sweeping changes of the Reform Act, absolutely nothing is targeted and narrow about this legislation.

However, there was a problem to be addressed. To be sure, nuisance litigation instigated by entrepreneurial plaintiffs' attorneys can be a drag on the economy. Defendants frequently settle these suits for significant sums to avoid the cost and uncertainty of trying the cases before juries. In addition to the dollar value of the settlement, defendants frequently expend significant sums of money and time in the period following the filing of the complaint. Defendants typically hire first-rate attorneys to undertake thorough investigations of the allegations to ascertain both the defendants' and the attorneys' potential exposure. These firms often rack up hundreds or even thousands of billable hours conducting extensive document reviews and exhaustive legal research in preparation for the first major judicial battle: The motion to dismiss. With fledgling first-year associates billing in excess of \$200 per hour,⁹⁴ even the costs of this preliminary activity can be enormous.

If the motion to dismiss is granted, the defendants have gotten off lightly. If the motion is denied, the plaintiffs have gained the upper

93. S. HRG. 105-420, *supra* note 26, at 15 (opening statement of Senator Christopher Dodd); *see also id.* at 5 (opening statement of Rep. Richard A. White) ("We have come up with a very limited bill, a bill that addresses only nationally-traded securities."); *but see* Prepared Statement of Senator Richard H. Bryan: "It seems to me that there is no reason to preempt the entire body of antifraud laws of all 50 States when there are only two claimed problems that even the proponents have identified." *Id.* at 39.

94. *See* Amy Vincent, *Second Wind*, THE AM. LAW., Aug. 2003 (reporting that the standard billing rate for first year associates at large New York firms was \$210 per hour, with the rate for top partners reaching \$650 per hour).

hand as the parties move to the negotiating table. The Reform Act was designed to dramatically alter this course of events by means of two of its main provisions, the heightened pleading requirements and the discovery stay.⁹⁵ As mentioned earlier, plaintiffs alleging fraud in the purchase or sale of securities must now plead with specificity the facts that form the basis of their claim of fraud.⁹⁶ Therefore, to file a legally sufficient complaint, plaintiffs often must have access to closely guarded information. Before the reform legislation, plaintiffs only needed to plead upon information and belief to gain access to inside information through the American legal system's liberal discovery rules. Now, plaintiffs are stymied at both stages. Not only must they plead specific facts that form the basis of their claims, but they are stripped of access to such information because of the discovery stay. The result is that many plaintiffs with colorable claims of fraud will be shut out of court.

To the extent that this state of affairs is the result of a reasoned legislative judgment carefully arrived at through an open, deliberative process, it is simply a bitter pill to swallow for many aggrieved investors. However, this legislative remedy for what was deemed to be a chronic ailment of the litigation system has caused at least one harmful side effect that has been largely overlooked. Hundreds of thousands of retirement investors, whose retirement nest eggs shrank as a result of fraudulent sales practices rampant in the insurance industry, were denied the chance to have their state law claims heard in state or federal courts.⁹⁷ These investors were purchasers of variable annuities, a group that saw their fraud claims dismissed after the passage of the Uniform Standards Act.⁹⁸

The circumstances surrounding this development seem all the more inappropriate when one considers the degree to which these abusive sales practices had proliferated.⁹⁹ Furthermore, various legal and nonlegal institutions began to develop considerable momentum toward addressing this problem.¹⁰⁰ A great deal of news media coverage focused on the problem of insurers inappropriately selling variable annuities into qualified plans.¹⁰¹ This coverage spurred the plaintiffs' bar into action, and many suits were filed.¹⁰² While some suits settled,

95. See *supra* notes 7-14 and accompanying text.

96. See *supra* notes 7-14 and accompanying text.

97. See *infra* notes 209-27 and accompanying text.

98. See *infra* notes 209-27 and accompanying text.

99. See *infra* Part V, Table 3.

100. See *infra* Part IV.

101. See *infra* notes 180-85 and accompanying text.

102. See *infra* notes 143-47 and accompanying text.

others were pending and more still may be brought.¹⁰³ In light of judicial expansion of fiduciary liability over the decades, there was good reason to believe that the courts would hold defendants to a heightened duty of disclosure.¹⁰⁴ The life insurance industry, in an attempt to clean up its image, developed a program whereby companies could undergo a review of their sales, marketing, and training practices, and receive an honor badge proclaiming that they carried out their business ethically.¹⁰⁵ Finally, the SEC and self-regulatory bodies like the NASD took steps to caution the public about when not to buy variable annuities.¹⁰⁶ They also warned and sanctioned those who sold variable annuities inappropriately.¹⁰⁷ All of these developments seemed to represent progress toward a meaningful change in the way life insurance companies sold their variable annuity products. But this multifarious reform movement was swiftly decapitated by the Uniform Standards Act.¹⁰⁸

II. SALES OF VARIABLE ANNUITIES IN QUALIFIED PLANS

Beginning in the mid-1980s, when employee participation in defined contribution plans began blossoming in this country,¹⁰⁹ life insurance companies started to experience an explosion in the sales of variable annuities.¹¹⁰ Variable annuities are retirement planning vehicles sold by life insurance companies and their registered representatives.¹¹¹ They are distinguishable from mutual funds by their two-phase design and tax-deferred status.¹¹² In the first phase, known as the accumulation or investment phase, the premiums paid by the purchaser are invested in subaccounts, akin to mutual funds, which contain stocks, bonds and money market instruments.¹¹³ During the accumulation

103. See *infra* notes 143-47 and accompanying text.

104. See *infra* Part IV-D.

105. See *infra* note 263 and accompanying text.

106. See *infra* Parts IV-A and IV-B.

107. See *infra* Parts IV-A and IV-B.

108. See *infra* Part IV-C.

109. See *infra* Part III-A, Table 1.

110. See *infra* Part V, Table 3.

111. SEC Investor Alert., *Variable Annuities: What You Should Know*, available at <http://www.sec.gov/investor/pubs/varannty.htm> (modified: 11/06/2003) [hereinafter SEC Investor Alert]. Throughout this Article, these sales agents are referred to variously as registered representatives, brokers, financial advisors, agents and broker-dealers.

112. SEC Investor Alert, *supra* note 111.

113. *Id.* The variable annuity is so named because the value of the assets in the investor's account will vary with the value of the subaccount. This contrasts with the fixed annuity, in which the premiums are invested in bonds and other fixed income instruments, producing a fixed return for the investor. *Id.*

phase, the investor's money grows on a tax-deferred basis, with the gain each year being reinvested in full, rather than being taxed.¹¹⁴ This is a substantial advantage: The money in the subaccount grows much faster over time than a comparable taxable investment, such as a mutual fund.¹¹⁵ This faster growth occurs because each year the investor is earning interest on that portion of the investment that would be lost to government taxation if it were a taxable vehicle.¹¹⁶ During the accumulation phase, the investor may transfer the money from one subaccount to another within the menu of subaccounts offered by the insurer. Such transfers may be desirable as a response to a shift in the market place or in one's attitude toward risk. However, if the investor wishes to withdraw any of the moneys during the accumulation phase, the insurer typically imposes substantial "surrender charges."¹¹⁷ Additionally, if the withdrawal occurs before the age of fifty-nine-and-a-half, a ten percent federal tax penalty may be assessed.¹¹⁸

When the accumulation phase is over, after age fifty-nine-and-a-half by law or at a later date by contract, the payout phase begins.¹¹⁹ At the start of the payout phase, the investor must choose either to receive the balance in his account as a lump sum payment or to annuitize the account. With the annuity option, the money accumulated during the investment period is turned into a periodic payout, usually a stream of monthly payments for the rest of the annuitant's lifetime. The benefit of the annuitization is that the investor will receive a guaranteed income for as long as he lives. The insurance company assumes the risk that the investor will outlive his assets.¹²⁰

Aside from tax deferral and the security of lifetime payments to the investor, the only other noteworthy benefit of variable annuities is the death benefit.¹²¹ The death benefit is a fairly insignificant form of investment insurance whereby if the purchaser dies during the accumulation phase, a named beneficiary is guaranteed to receive at least the amount of premiums paid.¹²² If the investments in the

114. *Id.*

115. Not all mutual funds are taxable (for example, municipal bond funds). Gains from mutual funds also are not taxable when the fund is placed in a qualified plan.

116. SEC Investor Alert, *supra* note 111.

117. *Id.*

118. *Id.*

119. *Id.*

120. *Id.* Of course, the investor assumes the risk that she will die prematurely and forfeit the balance of her account.

121. *Id.*

122. *Id.* The death benefit is rarely of much value to consumers because, given the historical growth of the stock market, it is very unusual for an investor to die with a net

subaccount lost value during the accumulation period, those losses will be absorbed by the insurer.¹²³ A variant of this feature is the stepped-up death benefit, which periodically locks in gains from the performance of the subaccount.¹²⁴ Each insurance company provides some version of the death benefit and a few offer other, more ancillary features, such as long-term care benefits bundled into the variable annuity package at an additional cost to the investor.

The benefits of a variable annuity, while attractive, come at a price: When an investor purchases a variable annuity, the investments become subject to various fees, charges, and commissions.¹²⁵ The average variable annuity charges a total of 2.09 percent per year against the assets under contract.¹²⁶ This rate includes an average charge of 0.82 percent per year for managing the subaccount portfolios and an average of 1.25 percent annual "mortality and expense" ("M&E") charge.¹²⁷ The M&E charge allegedly compensates the insurer for the actuarial risk it takes should the investor eventually annuitize his account.¹²⁸ The broker's commission also frequently comes out of the M&E charge.¹²⁹ An administrative fee, usually in the range of twenty-five to forty dollars per year is also typical.¹³⁰ Finally, there is the surrender charge. Usually in the range of five to nine percent, the surrender charge is a significant restriction on liquidity, requiring the investor to pay if he wants to withdraw funds within the first eight or ten years after the purchase of the annuity.¹³¹ The surrender charge is, in effect, a type

loss on his account. One industry insider estimated that the death benefit costs insurers ten to fifteen basis points. See Vanessa O'Connell, *Commissions Hunting: Look to 'M&E' Fees*, WALL ST. J., Mar. 30, 1998, at C1 (quoting Patrick Reinkemeyer, Publisher of Morningstar Inc.'s Variable Annuity/Life Performance Report). A more rigorous and formal examination of the cost of the simple death benefit concluded that the death benefit costs the average fifty-year-old contract purchaser three-and-a-half basis points, and that the stepped-up death benefit with a five percent rising floor costs twenty basis points. See Moshe Arye Milevsky & Steven E. Posner, *The Titanic Option: Valuation of the Guaranteed Minimum Death Benefit in Variable Annuities and Mutual Funds*, J. RISK & INS., Mar. 1, 2001, at 93.

123. SEC Investor Alert, *supra* note 111.

124. *Id.*

125. Mark Bautz, *Money Ranks the Best Variable Annuities*, MONEY, November 1996, at 134, 135.

126. Kimberly Lankford, *Boy, Have They Got a Deal for You*, KIPLINGER'S PERS. FIN. MAG., Apr. 1999, at 108, 110.

127. SEC Investor Alert, *supra* note 111.

128. *Id.*

129. *Id.*

130. *Id.*

131. *Id.*

of sales charge and is used to pay brokers' commissions.¹³² The commissions can be as high as seven percent, as compared to an average four percent commission on mutual fund sales.¹³³

Though these charges and fees may seem innocuous when viewed out of context, they are actually a significant drag on the investment's performance and a hindrance to the accumulation of wealth for retirement. Excluding surrender charges, the standard fees, on average, add up to 2.09 percent, and can reach as high as 2.50 percent.¹³⁴ By comparison, the fees associated with mutual funds average only 1.42 percent.¹³⁵

The comparison of fee structures between variable annuities and mutual funds is particularly significant because, when a variable annuity is purchased with money in a tax-sheltered account, the annuity is the functional equivalent of a mutual fund.¹³⁶ An investor could achieve the same financial benefits by purchasing a mutual fund (which would be tax deferred by virtue of being placed in the IRA or 401(k) account) and then purchasing an immediate annuity when he retires. Nevertheless, sales of variable annuities into such tax-qualified accounts have exploded in the last fifteen years, and this development has caused average investors to forfeit significant portions of their retirement savings.¹³⁷ For example, over a ten-year period, an investor who purchased a typical variable annuity with \$100,000 of his IRA money would, as a result of the fees and charges, end up with \$8590 less than he would have had with a mutual fund, assuming yearly investment earnings of ten percent.¹³⁸ If a loss of 8.59 percent of an average investor's retirement savings is not that sensational a figure, consider this: Annuity assets have hovered around \$900 billion to \$1 trillion since 1999.¹³⁹ With at least half of those assets coming from qualified

132. *Id.*

133. Carolyn T. Geer, *The Great Annuity Rip-off*, FORBES, Feb. 9, 1998, at 106, 107.

134. Ron Panko, *Can Annuities Pass Muster? Attorneys Take Insurance Companies to Court*, BEST'S REV., July 1, 2000, at 103.

135. *Id.*

136. See Geer, *supra* note 133, at 106-07; Karen Damato, *Do Annuities Belong in IRAs?*, WALL ST. J., Jan. 6, 2003, at R23. See also *infra* Part III-B.

137. See *infra* Part V, Table 3.

138. See Deborah Lohse & Bridget O'Brian, *Lawyers Seek Class Action Against Insurers Over Annuities*, WALL ST. J., Nov. 9, 1999, at C1.

139. VARDS Report: *Historic Annual Total Net Assets*, at <http://www.vards.com/pdf/AHAssetq203.pdf> (2003). According to the Variable Annuity Research & Data Service (VARDS), a variable annuities market research firm, total net assets in variable annuities was \$973,466,600 in 1999, \$956,450,600 in 2000, \$886,013,600 in 2001, \$796,662,300 in 2002, and \$880,101,000 as of June 30, 2003. *Id.* Other estimates are even higher. See Lohse & O'Brian, *supra* note 138 (estimating \$1.2 trillion in variable annuities assets in

plans, the sellers of annuities are potentially capturing hundreds of millions of dollars that ought to be financing Americans' retirements.

So why have investors paid so dearly to put so much tax deferred money into an expensive tax deferred investment? The most likely explanation is that life insurers and their representatives have foisted this product on trusting and confused investors because the insurers stand to make terrific profit margins on the sales. One industry insider estimated that the death benefit costs insurers ten to fifteen basis points (hundredths of a percent).¹⁴⁰ A more rigorous and formal examination of the cost of the simple death benefit concluded that the death benefit costs insurer three-and-a-half basis points in the case of the average fifty-year-old contract purchaser, and that the stepped-up death benefit with a five percent rising floor costs twenty basis points.¹⁴¹ When considering that the not-for-profit TIAA-CREF, a leading seller of variable annuities to qualified plans, levies an M&E charge of only seven basis points,¹⁴² a clearer picture begins to emerge. The 1.25 percent average M&E charge is almost pure profit for the insurance company. Assuming conservatively that if the M&E charge represents a one percent profit on all variable annuity assets under management, it is evident that the insurers have a powerful incentive to sell variable annuities instead of mutual funds. When this corporate profit motive is coupled with a sales agent's incentive to earn inflated commissions, the average investor faces a powerful persuasive force directing him to make the wrong purchase.

Beginning in 1998, plaintiffs' firms, most notably Milberg, Weiss, Bershad, Hynes & Lerach, sued major life insurance companies for improper sales of variable annuities into qualified plans. Among the defendants were Nationwide Financial Services, American Express Financial Corp., American United Life Insurance Co., SunAmerica Inc., Met Life, Prudential Financial Inc., and Hartford Life Insurance Co.¹⁴³ The American Express Financial Corp. case settled for \$215 million even before the litigation was certified as a class action.¹⁴⁴ Each complaint

1999).

140. See O'Connell, *supra* note 122 (quoting Patrick Reinkemeyer, Publisher of Morningstar Inc.'s Variable Annuity/Life Performance Report).

141. See Milevsky & Posner, *supra* note 122, at 108.

142. *Id.*

143. Panko, *supra* note 134, at 103; see also *Nationwide v. Nationwide Fin. Servs., Inc.* No. 98-CVH10-8393 (Ohio C.P., Franklin City) [hereinafter *Nationwide Complaint*]; *SunAmerica v. SunAmerica, Inc.* Case No. BC194082 (Cal. Sup. Ct., Los Angeles County) [hereinafter *SunAmerica Complaint*]; *AMEX v. American Express Fin. Corp., et al.*, No. MC 98-015681 (Minn. Dist. Ct., Hennepin County) [hereinafter *AMEX Complaint*].

144. Panko, *supra* note 134, at 103.

alleged various misdeeds in the sales of annuities dating back to 1985. But the central claim in these class actions, and the one on which the rest of this Article will focus, is that variable annuities are inappropriate investments for qualified plans, except in very limited circumstances.¹⁴⁵

Accusing defendants of breach of fiduciary duties, fraud, fraudulent concealment, and deceit, plaintiffs stressed the superior knowledge possessed by defendants and their “failure to state facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.”¹⁴⁶ While the claims came under various legal rubrics,¹⁴⁷ the theory of recovery generally boiled down to an assertion that defendants’ behavior amounted to a failure of disclosure.

III. EVOLUTIONARY SHIFTS IN THE WAY AMERICANS WORK AND SAVE FOR RETIREMENT

As will be explained more fully in Section III-B, providers of financial services have demonstrated a predatory streak that the legal system has been unable or unwilling to corral. But profit-driven corporations and the absence of an adequate legal response only make up part of the picture; societal changes also contribute to the need for a more vigorous legal response to the problems outlined above. The last decades of the twentieth century have witnessed major shifts in the way Americans work. Once upon a time, Americans worked at the office from nine to five, five days a week, year in and year out, until they retired with a gold watch and a pension. They paid their dues, working loyally and steadfastly, and were rewarded with financial security in their old age. These days, the concept of a career no longer means that a person will work for one or two large corporations for the duration of his work life.

145. See, e.g., SunAmerica Complaint, *supra* note 143, at ¶¶ 4-9.

146. Nationwide Complaint, *supra* note 143, at ¶ 64.

147. The causes of action pleaded in the AMEX complaint included deceptive trade practices, false or misleading advertising, consumer fraud, fraud, fraudulent concealment and deceit, breach of fiduciary duty/constructive fraud, negligent misrepresentation, negligence and negligence per se. AMEX Complaint, *supra* note 143, at ¶¶ 5, 19, 41, 49, 52, 57, 65, 68, 74, 82, 89, 96, 103, 109. The Nationwide complaint pleaded similar causes of action, adding negligent training and supervision. Nationwide Complaint, *supra* note 143, at ¶¶ 62, 69, 76, 83, 94, 99. The differences merely reflected differing state common law as the *Nationwide* case was brought in an Ohio state court and the *AMEX* case was brought in a Minnesota state court.

The average American worker now holds nine jobs before the age of thirty-two.¹⁴⁸

Loyalties between employers and employees have largely evaporated. Until the sweeping corporate consolidations of the 1980s and the concomitant layoffs, employees commonly moved only vertically through a firm, rather than laterally from firm to firm and industry to industry. There was a time when an employee could count on job security, provided that he performed with reasonable competence and reliability, and knew that upon retirement a pension was waiting that would allow him to retire with an adequate lifestyle.

This romantic picture of careerism began to change dramatically and painfully in the 1980s when firms began ruthlessly cutting costs by trimming their workforce. As workers felt the cold sting of unexpected layoffs and difficult mid-career job searches, an ethic of independence developed that gave rise to today's fractured and multi-faceted career patterns. More Americans are moving from job to job, working freelance, working from home, or starting their own consultancies than ever before.¹⁴⁹ Adapting to the new environment involved growing pains, but ultimately American workers saw great value in their new found flexibility casting this change as a liberation.¹⁵⁰

If the decrease in loyalty between labor and management came to be viewed as a win-win scenario, then the resulting loss in retirement security was not a mutually beneficial development. To be sure, the employers were happy. They achieved cost cutting not only in the short term through reduced compensation expenses, but also in the long term by reducing the amount of capital they had to set aside for retirement benefits. Industrial streamlining improved profitability and increased share prices. Not only did the corporations benefit, but top managers reaped huge rewards in the form of bonuses and stock options. However, no reciprocal benefit was reaped by other employees. Instead, employees found themselves struggling to develop strategies to provide for their retirements.

148. Employment Benefits Research Institute, *Issue Brief 249, An Evolving Pension System: Trends in Defined Benefit and Defined Contribution Plans*, at 24 (Sept. 2002) [hereinafter *EBRI Issue Brief 249*].

149. See, e.g., Nina Munk, *The Price of Freedom*, N.Y. TIMES, Mar. 5, 2000, § 6 (Magazine), at 50; Daniel H. Pink, *Free Agent Nation*, FAST COMPANY, December 1997/January 1998, at 131.

150. Munk, *supra* note 149, at § 6. "The free agent has a much better lifestyle . . . they can go snowboarding; they can decide when they want to work and when they don't want to work. It's an incredible lifestyle. I can't really think of a better way to spend your life." *Id.*

A. *Defined Benefit and Defined Contribution Plans*

The trend toward a more loosely structured work life over the last thirty years was accompanied by changes in the way employers helped their employees save for retirement. From the end of the second World War until the early 1970s, defined benefit pension plans were the norm for large private employers.¹⁵¹ In a defined benefit plan, the employee is assured of a certain benefit upon retirement, usually a monthly cash payment calculated based on the employee's tenure and annual salary in the final years of employment.¹⁵² The employer is responsible for making sure that the funds needed to pay retirees are available.¹⁵³ Defined benefit plans offer employees threefold guarantees regarding their pensions: Their pensions are guaranteed by the assets in the pension fund itself, by the overall solvency of the employer, and finally, by the Pension Benefit Guarantee Corporation.¹⁵⁴

The alternative to a defined benefit plan is a defined contribution pension plan, in which the employer contributes to the employee's account via a payroll deduction. The employer maintains control of the aggregated funds invested by all of its plan participants but must provide a range of investment options for each employee. The most common form of defined contribution plan is the 401(k) plan, created in 1978 when Congress added section 401(k) to the Internal Revenue Code.¹⁵⁵ An essential characteristic of the 401(k) and its relatives is that the account is the employee's property. The employer administers the account, but the employee owns it and carries it with him as he moves from job to job or stops working. Ultimately the employee must be responsible for making decisions about how to invest the funds in a defined contribution plan, and employees often do so on their own without the guidance of a plan administrator.

Whereas defined benefit pensions used to be the predominant form of retirement benefit in corporate America, since the late 1970s, defined contribution plans have taken the lead.¹⁵⁶ More Americans have been thrust into the role of guardian of their own retirement assets. In 1998,

151. See EBRI *Issue Brief 249*, *supra* note 148, at 4.

152. See Dana M. Muir, *The Dichotomy Between Investment Advice and Investment Education: Is No Advice Really the Best Advice?*, BERKELEY J. EMP. & LAB. L. 1, 4-5 (2002).

153. *Id.* at 5.

154. *CPR Needed*, PENSIONS & INVESTMENTS, Apr. 19, 1999, at 10.

155. The 401(k) plan is available to employees in the private sector. A 401(a) plan or 457 plan is the equivalent of a 401(k) plan but is available to government employees. A 403(b) plan is available to employees of public schools and organizations exempt from federal income tax under I.R.C. § 501(c)(3).

156. EBRI *Issue Brief 249*, *supra* note 148, at 4-5.

the year the annuities class actions were commenced, fifty-eight million American workers participated in defined contribution plans, as compared with forty-two million in defined benefit plans.¹⁵⁷ These statistics contrast markedly with the numbers from 1975, when only twelve million corporate employees had defined contribution plans and thirty-three million had defined benefit plans.¹⁵⁸ The trend is illustrated more fully in Tables 1 and 2.

Many factors contributed to the shift away from defined benefit to defined contribution plans. For one thing, Congress passed the Employee Retirement Income Security Act ("ERISA")¹⁵⁹ in 1974. An important aim of ERISA was to ensure the security of employee pensions by forcing employers to actually fund their pension programs.¹⁶⁰ As is often the case with well-intentioned social welfare legislation, perverse results ensued. While full funding of defined benefit pensions was achieved in many cases, vast numbers of employers turned away from defined benefit plans and established 401(k)s for their workforce.¹⁶¹ By offering minimal or no matching funds, employers save on both annual contributions and administrative costs.¹⁶² Thus, one unintended consequence of ERISA has been that employees have had to assume greater responsibility both in funding their retirements and making investment decisions.

Another reason for the rise of the defined contribution plan is that ERISA plans are complicated to administer, and the regulatory tangle is dense and frequently changing.¹⁶³ Relatively speaking, the regulatory requirements for defined contribution plans are fewer, simpler, and change less frequently.¹⁶⁴ According to one analysis of recent aggregate costs of regulatory changes, the costs of administering a defined benefit plan in 1981 was 140 percent greater than the cost of administering a 401(k) plan.¹⁶⁵ By 1996 the gap had widened to 210 percent.¹⁶⁶ One of the main sources of this disparity is the cost of premiums paid to

157. *Id.* at 5.

158. *Id.* at 6.

159. 29 U.S.C. §§ 1001 to 1461 (2000).

160. See *The Pension Temptation*, PENSIONS AND INVESTMENTS, Jan. 9, 1995, at 8.

161. See *id.* at 4-6.

162. *Id.* at 8.

163. See Jack VanDerhei & Craig Copeland, EBRI *Issue Brief 232, The Changing Face of Private Retirement Plans*, at 5 (Apr. 2001).

164. *Id.*

165. *Id.*

166. *Id.* at 6 (citing Edwin C. Hustead, *Trends in Retirement Income Plan Administrative Expenses*, PRC Working Paper 96-13, University of Pennsylvania, Pension Research Council).

TABLE 1: Private Pension Plans and Participants
Summary of Private-Sector Qualified Defined Benefit and Defined Contribution Plans and Participants, Selected Years, 1975-1998

	1975	1980	1985	1990	1992	1993	1994	1995	1996	1997	1998
Total Plans ^{ab} (Thousands)	311	489	632	712	708	802	690	693	696	720	730
Defined Benefit ^a	103	208	341	170	113	89	84	74	69	59	56
Defined Contribution ^a	208	341	462	599	620	619	616	624	633	661	674
Defined Contribution as Percentage of Total	67%	70%	73%	84%	87%	88%	89%	90%	91%	92%	92%
Total Participants ^{bc} (Millions)	45	58	75	77	82	84	85	87	92	95	99
Defined Benefit ^c	33	38	40	39	40	40	40	40	41	40	42
Defined Contribution ^c	12	20	35	38	42	44	45	48	51	55	58
Defined Contribution as Percentage of Total	26%	34%	47%	50%	52%	52%	53%	55%	55%	57%	58%

Source: Employee Benefit Research Institute tabulations based on U.S. Department of Labor, Pension and Welfare Benefits Administration, *Private Pension Plan Bulletin: Abstract of 1998 form 5500 Annual Reports* (Winter 2001-2002).

^aExcludes single-participant plans.

^bDue to rounding, sums of individual items may not equal totals.

^cIncludes active, retired, and separated vested participants not yet in pay status. Not adjusted for double counting of individuals participating in more than one plan.

TABLE 2: Private Plan Financial Trends

Summary of Private-Sector Qualified Defined Benefit and Defined Contribution Plan Trends, Selected Years 1975-1998

	1975	1980	1985	1990	1992	1993	1994	1995	1996	1997	1998
Assets ^{a,c} (\$Billions)	260	564	1,674	1,936	2,094	2,316	2,299	2,724	3,136	3,554	4,022
Defined Benefit	186	401	962	1,102	1,147	1,248	1,211	1,402	1,585	1,736	1,937
Defined Contribution	74	162	712	834	947	1,068	1,088	1,322	1,551	1,818	2,085
Defined Contribution As Percentage of Total Contributions ^{b,d} (\$Billions)	28%	29%	43%	43%	45%	46%	47%	49%	49%	51%	52%
Defined Benefit ^e	24	43	23	30	35	52	39	41	36	30	35
Defined Contribution ^e	13	24	76	81	94	102	105	117	134	148	167
Defined Contribution As Percentage of Total Benefit Payments ^{b,e} (\$Billions)	35%	36%	77%	73%	73%	66%	73%	74%	79%	83%	83%
Defined Benefit	19	35	129	136	152	156	164	183	213	232	273
Defined Contribution As Percentage of Total	6	13	63	64	75	77	81	98	116	135	162
	32%	37%	49%	47%	49%	49%	50%	53%	55%	58%	59%

Source: Employee Benefit Research Institute tabulations based on U.S. Department of Labor, Pension and Welfare Benefits Administration, *Private Pension Plan Bulletin: Abstract of 1998 form 5500 Annual Reports* (Spring 1998); and *Private Pension Plan Bulletin: Abstract of 1998 form 5500 Annual Reports* (Winter 2001-2002).

^aExcludes single-participant plans.

^bDue to rounding, sums of individual items may not equal totals.

^cExcludes funds held by life insurance companies under allocated group contracts for payment of retirement benefits. These funds make up roughly 10-15 percent of total private pension plan assets.

^dIncludes both employer and employee contributions.

^eIncludes both benefits paid directly from trust and premium payments made by plans to insurance carriers. Excludes benefits paid directly by insurance carriers.

the Pension Benefit Guarantee Corporation, as well as the cost associated with funding the pension, both of which are incurred only for defined benefit plans.¹⁶⁷

Another factor contributing to the demise of defined benefit plans was a change in the tax law in 1987.¹⁶⁸ In that year, Congress capped at \$150,000 the amount of annual compensation that can be taken into account for the purposes of calculating contributions or benefits in a qualified plan.¹⁶⁹ Congress also placed a limit of \$125,000 on the maximum annual payout from a defined benefit plan for a retired employee.¹⁷⁰ While such an annual pension benefit would be a luxury for most, it clearly would represent a substantial "hardship" for retiring executives used to annual compensation in excess of one million dollars.¹⁷¹ Some have argued that this limitation on the generosity of executive pensions led top management to sour on defined benefit plans for all employees.¹⁷² Because the top brass no longer saw defined benefit plans as meaningful engines for the generation of their own retirement income, they lost much of their motivation to be generous to the rank and file.¹⁷³

B. Unsophisticated Investors Are Overmatched in the Financial Services Marketplace

When financial services providers and the financial advisors they employ contemplate the pool of retirement assets available in the defined contribution market, they see dollar signs. As of June 30, 2003, the entire retirement investment market in the United States was estimated to be \$10.6 trillion.¹⁷⁴ Of this total, approximately \$4.2 trillion, or forty percent, was in defined benefit plans.¹⁷⁵ Another \$3.5 trillion, or thirty-three percent, was in defined contribution plans, and the remaining twenty-seven percent, or \$2.86 trillion, was placed in Individual Retirement Accounts independent of any employment-based retirement plan.¹⁷⁶ Recall now the one percent profit margin to be

167. *Id.*

168. I.R.C. § 4980A(c)(1) (1987).

169. See Mike Clowes, *Why Capping Pensions Hurts All Workers*, PENSIONS & INVESTMENTS, Nov. 25, 1996, at 10.

170. *Id.*

171. *Id.*

172. *Id.*

173. *Id.*

174. *DC Plan Assets Climb 7% to \$3.4 Trillion at Mid-Year*, DC PLAN INVESTING, June 10, 2003, at 1, 2.

175. *Id.* at 2.

176. *Id.*

earned each year on every dollar of variable annuities assets under management in the context of a potential pool of \$3.5 trillion in defined contribution assets.¹⁷⁷ This prize drove the sales and marketing strategies of insurers and led them to push variable annuities even when the variable annuities are not the most appropriate investment choice for the customer.

Whereas investments in stocks and bonds were once mainly the exclusive province of the well-to-do, by the 1980s a huge new class of investors had entered the field of stock market investing.¹⁷⁸ An important tool for this class was the mutual fund, a device which offered the investor access to the higher returns of the equities markets, with the mitigating influence of diversification and the delegation to a centralized agent of the task of making particular investment decisions. Having learned to rely on Fidelity and Vanguard to invest their money and make it grow over a period of years, investors solved a large part of the problem of providing for their retirements. But as workers begin to approach retirement age, there comes a time when asset growth ceases to be the focus of a retirement investment plan and the emphasis shifts to income generation and the managing of tax consequences.

To respond to this need, financial services corporations stepped in to offer comprehensive services that seemed to offer the entire package.¹⁷⁹ The alluring promise of the variable annuity purveyor is "Give us your money, choose from a menu of investment approaches keyed to your particular attitude toward risk, and we'll take care of everything from there." This appealing offer, as we have seen, has proven to be fraught with traps.

Investors have good reason to rely on the expertise and services offered by financial advisors, and those advisors and the companies they represent have a right to make a profit on their products and services. Moreover, the concept behind the design of a variable annuity is compelling. If people want to pay a premium for the comfort of a guaranteed lifetime income and tax-deferred earnings, then they should be able to choose to do so. The problem is that investors have not been given enough of an explanation to recognize that there is another way of achieving these two goals while keeping more of their money. The unsophisticated purchaser does not realize that the same delightful

177. See *supra*, Part II.

178. See James A. Fanto, *We're All Capitalists Now: The Importance, Nature, Provision and Regulation of Investor Education*, 49 CASE W. RES. L. REV. 105 (1998).

179. See Donald Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627, 682-83 (1996).

combination can be achieved by unbundling the two features: Invest in a mutual fund and, if you wish, buy an annuity when you retire. This is substantially cheaper and accomplishes the same financial result while providing additional flexibility and liquidity. The question becomes, should the seller have a duty to disclose that there are cheaper ways to arrive at the same result? The answer is unequivocally yes.

IV. A MULTIFACETED RESPONSE TO ANNUITIES SALES PRACTICES

Beginning in early 1998, reporters in the financial press began to call attention to the problem of annuities being sold into qualified plans. Forbes Magazine devoted an entire cover to a story entitled, "The Great Annuity Rip-Off."¹⁸⁰ The cover depicted a salesman covering a customer's eyes while motioning him to sign on the dotted line.¹⁸¹ In very large type, the cover exclaimed: "Don't be a sucker! Variable annuities are a lousy investment."¹⁸² The Wall Street Journal soon followed suit, though in somewhat more muted tones.¹⁸³ All of the reporting reached the same conclusion: Life insurance companies were picking the pockets of investors by selling them completely inappropriate products that the investors would never have purchased if they really understood all the complicated issues implicated in their investment decision.¹⁸⁴ Spurred into action by the revelations in the press, the plaintiffs' bar took on the case later in the year, filing the class actions discussed earlier.¹⁸⁵

While journalists were attempting to arm the public with information and plaintiffs' attorneys were trying to obtain remedies in the courts, regulatory and self-regulatory agencies were also on the job. Both the SEC and the NASD investigated the annuities industry and concluded that there was, indeed, a problem.

A. *The Response of the NASD*

The NASD responded fairly aggressively toward annuities sellers. In fact, the NASD was actually ahead of the plaintiffs' firms in sensing that something was amiss. In June 1997, a full year before the first class

180. See Geer, *supra* note 133. It appears as though the NASD may have been on the case six months before the Geer article. The NASD was investigating variable annuities sellers, but the nature of the investigation was not entirely clear. See *infra* Part IV-A and notes 186-88.

181. FORBES, Vol. 161, No. 3 (Feb. 9, 1998).

182. *Id.*

183. David Frannecki, *Caution Is Urged on Annuities and IRAs*, WALL ST. J., July 20, 1998, at C20

184. See, e.g., Geer, *supra* note 133.

185. See *supra* Part II and notes 143-46.

action complaints were filed, the NASD was already focusing on this problem.¹⁸⁶ Speaking at a compliance conference sponsored by the National Association for Variable Annuities in Washington, Roger B. Sherman, the vice president of NASD Regulation, Inc. (NASDR), revealed that the NASDR was investigating improper annuities sales practices.¹⁸⁷ Conveying the NASDR's concerns to the conference participants, he asked, "[i]s the tax deferral aspect of a policy balanced against a presentation of high fees plus the time for the tax-deferred aspect to outweigh the high fees? . . . Are you analyzing? . . . Did the investment benefit the *customer or the registered representative*?"¹⁸⁸

The NASD issued a Notice to Members in 1999 gently prodding the insurance industry to curtail the practices alleged in the class actions.¹⁸⁹ In the Notice, the NASD informed insurance companies and their representatives of the measures to be taken when recommending the purchase of variable annuities with moneys placed in qualified plans.¹⁹⁰ Summing up the problem, the NASD pointed out that while variable annuities in qualified plans "provide most of the same benefits to investors as variable annuities offered outside of a tax-qualified retirement plan, they do not provide any additional tax deferred treatment of earnings beyond the treatment provided by the tax-qualified retirement plan itself."¹⁹¹ The NASD concluded that, when recommending such an investment, the representative "should disclose to the customer that the tax deferred accrual feature is provided by the tax-qualified retirement plan and that the tax deferred accrual feature of the variable annuity is unnecessary."¹⁹² Further constraining annuities sellers, the Notice instructed them to recommend variable annuities in qualified plans only when the other features of variable annuities—mainly the guaranteed death benefit—justify the recommendation.¹⁹³

In addition to the Notice, the NASD took disciplinary action against several insurers.¹⁹⁴ In December 2002 the NASD fined American

186. *NASDR Focuses on Internal Supervision*, INS. REGULATOR, July 7, 1997, at 1.

187. *Id.*

188. *Id.* (emphasis added).

189. See NASD Notice to Members 99-35, *The NASD Reminds Members of their Responsibilities Regarding the Sales of Variable Annuities*, 229 (May 1999) [hereinafter NASD Notice to Members 99-35].

190. *Id.* at 230-32.

191. *Id.* at 231.

192. *Id.*

193. *Id.*

194. See Jeffrey S. Puretz & Nicole Griffin, *NASD Turning up the Pressure on VA Suitability*, LIFE & HEALTH/FIN. SERVICES EDITION, Apr. 7, 2003, at 36; Jeff Benjamin &

Express Financial Advisors \$350,000, citing defects in its sales, training, and marketing practices involving variable annuities in qualified plans, and noting that the proper role of sales agents was to *explain* and not just disclose the fees, charges, and commissions that variable annuities carry.¹⁹⁵ In what was probably the most explicit and enlightened rebuke to date by a regulatory or self-regulatory body, the NASD noted that American Express representatives “failed to compare and contrast variable annuities with mutual funds in those instances where the customer’s needs might have been better met through the purchase of mutual funds.”¹⁹⁶ This disciplinary action embodied one of the most important aspects of the claims in the class action complaints. Central to the plaintiffs’ theory was the notion that if investors had been aware of and understood all the facts, the investors would have purchased mutual funds and preserved an option to annuitize later.¹⁹⁷ Specifically, had the investors been shown a comparison of all the costs associated with a variable annuity alongside those levied for mutual funds, they would have been appropriately informed and would have chosen to purchase mutual funds.¹⁹⁸ But because of the high commissions earned by salesmen and the high profit margins reaped by their corporate principals, annuities were pushed unreasonably while information, analysis, and explanation was not forthcoming.¹⁹⁹

B. *The Response of the SEC*

While the NASD was issuing its Notice to the annuities industry itself, the SEC’s response to the variable annuities litigation came in a

Rick Miller, *Short Interests: Amex Fined for Suitability Infractions*, INVESTMENT NEWS, December 9, 2002, at 2 (noting that in 2001, NASD fined two firms a total of \$142,500 and six other firms a total of \$112,000).

195. Press Release, NASD, NASD Fines American Express Financial Advisors \$350,000 for Improper Sales of Variable Annuities and Life Insurance, (December 4, 2002) [hereinafter NASD Press Release].

196. *Id.*

197. See AMEX Complaint, *supra* note 143, at ¶15 (“the price of tax-deferral is the very substantial, and often exorbitant, fees charged by the sellers of deferred annuities—fees that substantially exceed the fees charged for similar non-annuity investment products like mutual funds”); AMEX Complaint, *supra* note 143, at ¶17 (“If a customer is seeking an annuity feature (*i.e.* fixed payments for life) for retirement, an immediate annuity can invariably be purchased at the time the investment is withdrawn at the end of the investment period (for example, upon retirement”).

198. AMEX Complaint, *supra* note 143, at ¶36 (claiming that had plaintiffs been “informed of the true nature of the investment before it was made—insurance features, high fees, and loss of liquidity in exchange for unnecessary tax deferral—they would not have purchased the deferred annuities.”). AMEX Complaint, *supra* note 143.

199. See *supra* notes 125-42 and accompanying text.

warning to the investing public about the pitfalls of purchasing variable annuities.²⁰⁰ In an investor alert published on the SEC's website, the SEC highlighted the familiar problems with variable annuities in qualified plans.²⁰¹ This thorough and highly readable²⁰² explanation of variable annuities revealed to consumers in no uncertain terms, and with the use of conspicuous typographical cues, the information that sellers of annuities should have been explaining all along.²⁰³ Early in the Alert, the reader's attention is drawn to the high costs involved in purchasing a variable annuity.²⁰⁴ Then comes the key point: Set off from the rest of the text is a large box with the word "Caution!" in bold at the top, followed by:

Other investment vehicles, such as IRAs and employer-sponsored 401(k) plans, also may provide you with tax-deferred growth and other tax advantages In addition, if you are investing in a variable annuity through a tax-advantaged retirement plan (such as a 401(k) plan or IRA), you will get *no additional tax advantage* from the variable annuity. Under these circumstances, consider buying a variable annuity only if it makes sense because of the annuity's other features, such as lifetime income payments and death benefit protection.²⁰⁵

While this statement from the SEC was a promising signal about its intent to deal with a serious problem, the statement did not carry much weight as a disciplinary response. For one thing, this communiqué, by its very nature, was only a public disclosure. It did not impose any constraints on the sellers of annuities and did not carry the force of law. Indeed, even as a disclosure, it was only effective to the extent that investors actually read it. One wonders how many investors would find their way to the part of the SEC website where this Alert is posted. For that matter, a substantial percentage of the public probably does not even know what the SEC is, so the reach of this apparently well meaning gesture seems quite limited.

Moreover, apart from its infirmity as a "soft" expression of public policy, the SEC Alert is deficient on its face. By focusing investors'

200. SEC *Investor Alert—Variable Annuities: What You Should Know*, available at <http://www.sec.gov/investor/pubs/varanntty.htm> (last visited Nov. 13, 2003) [hereinafter SEC Investor Alert].

201. *Id.*

202. In this case, at least, the SEC has heeded its own mandates regarding the use of plain English in securities-related documents intended for public consumption.

203. SEC Investor Alert, *supra* note 200.

204. *Id.*

205. *Id.*

attention only on the problem of duplication of tax deferral and encouraging investors to purchase variable annuities on the basis of a desire for guaranteed retirement income, the Alert arguably does more harm than good.²⁰⁶ An investor who has read this advice would believe that the government agency responsible for investor protection and education endorses the purchase of variable annuities with qualified plan moneys on the basis of the annuitization function alone. This is patently bad advice. The two-phase nature of a variable annuity requires an investor to invest money today in order to annuitize tomorrow. This requirement reduces investor liquidity by locking the funds into an investment vehicle that imposes surrender charges for early withdrawal. The more appropriate course of action for an investor seeking lifetime payments is to invest today in less expensive securities, like mutual funds, and purchase an immediate annuity when the investor is ready to turn capital into a regular and lifelong stream of income.²⁰⁷

By the end of 1999, there seemed to be a reasonable basis to believe that the annuities affair was headed toward a positive resolution. The NASD had been investigating and disciplining. Both the NASD and SEC had alerted the public about the problem, so perhaps investors understood the issues and would not be fooled again. The companies themselves had been chastened, or at least frightened, by the class actions. And, whether the companies signed a settlement agreement or merely took the misfortunes of their industry compatriots as a cautionary tale, the companies ought to have cleaned up their acts.²⁰⁸ They had also learned that the press and the plaintiffs' bar were watching vigilantly for any misstep. Several cases were still working their way through the courts with a fair expectation of success. Taken together, these developments seemed encouraging. But any real optimism about the future good behavior of the insurance industry would have been misplaced.

C. *The Annuities Cases in the Courts*

While the NASD and SEC responded to the litigation (and earlier class actions alleging fraudulent sales of life insurance)²⁰⁹ by reaffirming the

206. The most recent NASD pronouncement on the problem also suffers from this infirmity. See NASD Press Release, *supra* note 195 and accompanying text.

207. See, e.g., Carolyn T. Geer, *Finally, a Warning About Annuities*, FORTUNE, July 5, 1999, at 212 (explaining that the subsidiary benefits of variable annuities rarely justify purchasing one for a qualified plan). See also AMEX Complaint, *supra* note 143, at ¶17.

208. See *infra* text accompanying note 263.

209. See *supra* Parts IV-A and IV-B.

importance of consumer protection and acknowledging the vulnerability of unsophisticated consumers in the hands of brokers and dealers,²¹⁰ Congress took a much different track, passing the Uniform Standards Act to fortify and extend the reach of the Reform Act.²¹¹ As we have seen, under the Uniform Standards Act, actions alleging fraud in the sale of "covered securities" must be brought in federal court under federal law.²¹² In 2000 when the federal courts began finding that variable annuities fell under the Uniform Standards Act's definition of "covered securities,"²¹³ the curtain dropped on the variable annuities litigation before it ever got a proper audience.

The first fatal blow to the annuities class actions came in 2000 in *Lander v. Hartford Life & Annuity Insurance Co.*²¹⁴ The *Lander* action was filed as a class action in a Connecticut state court in 1998. Plaintiffs' allegations were similar to those of the SunAmerica and Nationwide plaintiffs. The causes of action pleaded were all based on Connecticut state law.²¹⁵ Hartford Life removed the case to federal court, citing the Uniform Standards Act, which requires removal of "any covered class action brought in any State court involving a covered security."²¹⁶ In an unpublished decision, the district court dismissed the case, and plaintiffs appealed to the United States Court of Appeals for the Second Circuit.²¹⁷

Although it declined to discuss the merits of the suit, the circuit court did state that "if funds set aside through a tax deferred investment vehicle, such as a 401(k) plan or IRA account, are used to purchase a variable annuity contract, the policyholder will receive no additional tax benefit. This tax redundancy forms the basis for the plaintiffs' suit."²¹⁸

210. See NASD Notice to Members 99-35, *supra* note 189; SEC Investor Alert, *supra* note 200.

211. See *supra* Part I.

212. *Id.*

213. *Id.*

214. 251 F.3d 101 (2d Cir. 2001).

215. *Id.* at 105-06, 109-10.

216. *Id.* at 106 (quoting 15 U.S.C. § 77p(c) (2001)).

217. *Id.* at 107.

218. *Id.* at 106. I quote this material simply because it highlights the paucity of any judicial pronouncements in this largely confidential dispute; it is one of the only instances of the class allegations appearing in any federal reporter. The only other discussions of class allegations appear in the other cases dismissing the state claims on identical SLUSA preemption grounds. See, e.g., *Herndon v. Equitable Life Ins. Co.*, No. 02CV73, 2002 WL 320066806 (S.D. Ga. Aug. 30, 2002), *aff'd*, 325 F.3d 1252 (11th Cir. 2003); *Patenaude v. Equitable Life Assurance Soc'y of the United States*, 290 F.3d 1020 (9th Cir. 2002); *Dudek v. Prudential Sec. Inc.*, 295 F.3d 875 (8th Cir. 2002); *Araujo v. John Hancock Life Ins. Co.*, 206 F. Supp. 2d 377 (E.D.N.Y. 2002).

The court proceeded to address the crucial question of whether a variable annuity was a “covered security” as defined in the Uniform Standards Act.²¹⁹ Under the Uniform Standards Act, “a ‘security is a covered security if [it] is issued by an investment company that is registered, or that has filed a registration statement, under the Investment Company Act of 1940.’”²²⁰

The court held that a variable annuity was a “covered security” under the Uniform Standards Act by referring to the U.S. Supreme Court’s 1959 ruling²²¹ in *SEC v. Variable Annuity Life Insurance Co. of America* (“VALIC”).²²² In *VALIC* the Supreme Court held that even though variable annuities are a kind of hybrid investment product (part insurance, part security), they must be registered as securities under the Securities Act of 1933,²²³ and issuers must comply with the Investment Company Act of 1940.²²⁴ The court in *Lander* concluded that variable annuities must therefore be covered securities under the Uniform Standards Act and that removal was proper.²²⁵ Further, because no federal causes of action were pleaded, the Uniform Standards Act required dismissal of the case.²²⁶

In dismissing the case, the Second Circuit tolled the death knell for these class actions. In federal circuit after federal circuit, the courts have uniformly dismissed annuities cases under the Uniform Standards Act.²²⁷ The practical upshot of the Uniform Standards Act cases was the end of the variable annuities litigation. Plaintiffs are foreclosed from petitioning state courts for any remedy arising from the purchase or sale of variable annuities. Plaintiffs may continue to bring state law claims in federal court on an individual basis, but neither state court actions nor federal class actions based on state statutory or common law are

219. *Lander*, 251 F.3d at 108-09.

220. *Id.* at 109 (quoting 15 U.S.C. § 77r(b)(2)). See also Investment Company Act of 1940, 15 U.S.C. § 80a-1 to -b-21 (2000). Although insurance companies are not investment companies under the Investment Company Act, the variable annuities they sell must contain separate investment accounts that must be registered with the SEC pursuant to the 1940 Act. *Prudential Ins. Co. of Am. v. SEC*, 326 F.2d 383, 388 (3d Cir. 1964), cert. denied, 377 U.S. 953 (1964).

221. *Lander*, 251 F.3d at 109.

222. 359 U.S. 65 (1959).

223. *VALIC*, 359 U.S. at 66; 15 U.S.C. § 77a-bbbb.

224. *VALIC*, 359 U.S. at 70-72.

225. *Lander*, 251 F.3d at 109.

226. *Id.* at 110. The heightened pleading requirements and discovery stay imposed by the Reform Act evidently led plaintiffs to decide that pleading federal causes of action would pose insurmountable informational hurdles. See *supra* Part I.

227. See *supra* text accompanying notes 217-18.

permitted.²²⁸ As a result, the aggregative force of Rule 23 litigation has been undermined, and the search for a judicial remedy for these insurance industry wrongdoings evaporated. In the end, legislation that was touted for its salutary effects on corporate disclosure succeeded in undermining a common law process that was working effectively toward redressing wrongs caused by defective disclosure.

D. What the Courts Might Have Done Had the Cases Not Been Dismissed

Had the Uniform Standards Act not operated to terminate the claims of annuities plaintiffs, then the courts would not have had to look far to find a basis for finding that the defendants' disclosures were inadequate. If the cases had been heard on the merits, then the defendants could have argued that they fulfilled their disclosure requirements. Because most of the causes of action required plaintiffs to prove a material misstatement or omission, the defendants would have been quick to demonstrate that they had fully disclosed the nature of their products and all of the fees and charges involved. But as the NASD understood, in these types of transactions, more than simple revelation of the features of the product should be required.²²⁹ A heightened duty of disclosure, akin to that of a fiduciary, should have been imposed. Indeed it does not seem far fetched to believe that the courts would have done so.

1. The Fiduciary Duty of Financial Advisors and Others Who Sell Variable Annuities. The role of the fiduciary is long established in Anglo-American jurisprudence. The law of fiduciaries creates and orders, in various circumstances, important statuses and relationships between actors in society. Familiar examples abound: Members of partnerships owe each other fiduciary duties,²³⁰ and corporate directors owe fiduciary duties to shareholders.²³¹ Trustees, bailees, and guardians are among the most ancient classes of fiduciaries, with the roots of their statuses stretching as far back as Roman Law.

But if the law of fiduciaries is an ancient story, it also has a modern chapter. In the twentieth century, the label "fiduciary" has been affixed to a growing number of public actors, such as physicians and psychiatrists, as well as union leaders who represent their members in dealings

228. *Lander*, 251 F.3d at 113.

229. *See* Poretz & Griffen, *supra* note 194.

230. *See, e.g.*, *Meinhard v. Salmon*, 164 N.E. 545, 547-48 (N.Y. App. 1928).

231. *See, e.g.*, *Smith v. Van Gorkom*, 488 A.2d 858 (1985).

with management.²³² Banks act as fiduciaries with respect to the funds their customers deposit, and in some circumstances, majority shareholders of a corporation owe fiduciary duties to minority shareholders.²³³

In the field of financial services, the question of whether financial advisors are fiduciaries yields a complicated answer. Plan administrators are considered fiduciaries under ERISA,²³⁴ as well as under state and federal common law.²³⁵ The fiduciary status of stockbrokers, on the other hand, occupies a somewhat murkier realm.

The relationships of individual investors with their brokers vary greatly. At one end of the spectrum, when a customer employs a broker at a retail investment firm, such as Charles Schwab, Inc., merely to execute transactions in securities that the customer has designed, the broker clearly is not acting as a fiduciary, except in the execution of the transaction.²³⁶ At the other end, a wealthy investor frequently entrusts his broker with a well-funded account that includes cash and securities. The wealthy investor deploys the broker as his agent to manage the account as the broker sees fit. In such cases the customer relies on the broker's experience and expertise to manage the "discretionary account." Just as the previous example typifies the clear-cut case of a non-fiduciary, the broker managing a discretionary account represents the paradigmatic case of broker-as-fiduciary. In managing a discretionary account, a broker is often responsible for deciding how a client's assets will be allocated. Many asset allocation decisions are made independently by the broker who confers with his client with varying frequency, depending on the relationship.

Whatever the details of the relationship, the broker, as a fiduciary, owes his client a duty to act "with the utmost good faith."²³⁷ The scope of this duty in various situations is not always clear, but the general principle remains: The fiduciary is to act in the client's best interests and is not to pursue his own interests.

232. Tamar Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795, 796.

233. See, e.g., *Pepper v. Litton*, 308 U.S. 306 (1939); *Zahn v. Transamerica Corp.*, 162 F.2d 36, 42 (3d Cir. 1947).

234. See *infra* Part IV-D-2 and text accompanying notes 243-47.

235. *Miller v. Lay Trucking Co.*, 606 F. Supp. 1326 (N.D. Ill. 1985).

236. See, e.g., *Robinson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 337 F. Supp. 107, 111 (N.D. Ala. 1971) ("The [fiduciary] relationship of agent and principal only existed between [broker and customer] when an order to buy or sell was placed, and terminated when the transaction was complete.").

237. See *Twomey v. Mitchum, Jones & Templeton, Inc.*, 69 Cal. Rptr. 222, 236 (Cal. Ct. App. 1968) ("The relationship between broker and principal is fiduciary in nature and imposes on the broker the duty of acting in the highest good faith toward the principal.").

Between these two ends of the spectrum are many legal theories governing the existence of a fiduciary duty.²³⁸ Even when there is no

238. For an excellent survey of the varying legal approaches to the question, see Carol R. Goforth, *Stockbrokers' Duties to Their Customers*, 33 ST. LOUIS U. L.J. 407, 418-31. A summary of Goforth's exposition follows. A minority view holds that a stockbroker always owes a fiduciary duty to the customer. *Id.* at 418-20; see, e.g., *Marchese v. Shearson Hayden Stone, Inc.*, 734 F.2d 414, 418 (9th Cir. 1984); *Roth v. Roth*, 571 S.W.2d 659, 668 (Mo. Ct. App. 1978).

A related approach embraces the law of agency, reasoning that the broker, as an agent, owes a fiduciary duty. Goforth, *supra*, at 420. For example, the Supreme Court of Arizona has stated that "there is no quarrel with the proposition of law that *when a broker serves as a customer's agent*, he is a fiduciary and owes his principal a duty to communicate certain information to him." *Walston & Co. v. Miller*, 410 P.2d 658, 660 (Ariz. 1966) (en banc) (emphasis added); see also *Black v. Shearson, Hammill & Co.*, 72 Cal. Rptr. 157, 160 (Ct. App. 1968) (explaining that a "stockbroker owes [a fiduciary] duty to his customers, whom he ordinarily serves as agent.").

Still other courts emphasize the existence or absence of a discretionary account, finding a fiduciary duty only in the former case. Goforth, *supra*, at 422-25; *Shearson Hayden Stone, Inc. v. Leach*, 583 F.2d 367 (7th Cir. 1978); *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951 (E.D. Mich. 1978); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Boech*, 377 N.W.2d 504 (Wis. 1985). Some courts take a more impressionistic and fact-specific approach to determine whether the broker is acting with the trust and confidence of the client. Goforth, *supra*, 425-27. Under this approach, fiduciary relationships "frequently arise out of trust and confidence consensually placed in the superior knowledge, skill or judgment of another." *Steinbrugge v. Haddock*, 281 F.2d 871, 874 (10th Cir. 1960). While this method of determining the existence of fiduciary duties seems to cast a wide net over many interactions between clients and brokers, courts have been careful to balance the breadth of the inquiry with a limitation on the ability of clients to rely willy-nilly on the broker's expertise. In this connection note the restrictive language in *Walston*, the Arizona case cited above, which should be read alongside the following quotation from that case: "As a general proposition, a broker's duty is complete, and his authority ceases, when the sale is made and the receipts therefrom fully accounted for." *Walston*, 410 P.2d at 661 (quoting *Pacific Trading Co. v. Sun Ins. Office*, 13 P.2d 616 (Or. 1932)). See also *Steinbrugge*, 281 F.2d at 874

(we do not think the courts have ever gone so far as to allow one person to rely with impunity upon the superior business judgment of another, merely because he so chooses, and thus raise an enforceable fiducial relationship. He cannot blindly follow the counsel of the other party simply because it is superior.).

Similarly fact sensitive is the "control test" employed by some courts. Goforth, *supra*, at 427-29; see *Leboce, S.A. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 709 F.2d 605 (9th Cir. 1983); *Paine, Webber, Jackson & Curtis, Inc. v. Adams*, 718 P.2d 508 (Colo. 1986). Using the "control test," courts have asked whether investors have "for all practical purposes relinquish[ed] control over their investment decisions to their brokers and place their confidence in their brokers' superior knowledge and level of experience. At the same time, we recognize that brokers should not be the insurers of their customers' accounts." *Adams*, 718 P.2d at 517. The multifarious factual inquiry includes factors such as the broker's past activities as investment advisor, the extent to which the customer followed the broker's advice, the extent to which the broker trades without the customer's prior approval, the frequency of communications between the broker and customer, the

discretionary account, courts have held that a fiduciary duty exists if the broker is found to control the client's account. Sometimes courts use evidentiary presumptions to shift the burden of proving or disproving the existence of a fiduciary relationship to one party or the other.

Yet another approach is the "shingle theory," under which an investment professional who "holds [himself] out" as a "financial advisor" or "financial planner" is deemed to have made an "implied representation that he will deal fairly with [his] customers."²³⁹ The shingle theory has been adopted by statute in some states in consumer protection legislation, which confers the status of a fiduciary upon financial planners or financial advisors who advertise themselves as such.²⁴⁰ From a choice of law perspective, this legislative reality has guided plaintiffs' attorneys in their choice of forum for filing some annuities class actions.²⁴¹ Of course, since *Lander*, this forum shopping aspect has, as a practical matter, become moot.²⁴²

2. The ERISA Analogy: Financial Advisors Are Akin to ERISA Plan Administrators. Private stock brokers and investment advisors are not the only source of investment advice. Many people, in their capacities as employees, benefit from the financial advice of their employers' plan administrators.²⁴³ Plan administrators are financial

investment sophistication of the customer, and the degree of trust and confidence reposed in the broker. *Id.*

Probably the most stringent test adopted by some courts is the "special agreement test." Under this test, a fiduciary duty will not be imposed absent some evidence of an agreement between the broker and customer regarding the level of care owed by the broker. Goforth, *supra*, at 430-32; McGinn v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 736 F.2d 1254 (8th Cir. 1984) ("Absent a special agreement to the contrary, a licensed broker owes his customer only the duty to exercise due care in executing all instructions expressly given to him by the principal.") *Id.* at 1258 (quoting Rude v. Larson, 207 N.W.2d 709, 711 (Minn. 1973) (per curiam)).

239. Langevoort, *supra* note 179, at 680.

240. 2002 MINN. STAT. § 45.026 (2002) ("Persons who represent that they are financial planners have a fiduciary duty to persons for whom services are performed for compensation."). NEV. REV. STAT. 628A.010 (2003) (defining financial planner as one "who holds himself out as qualified to" advise on "investment of money or . . . provision of income to be needed in the future"); NEV. REV. STAT. 628A.020 (2003) ("A financial planner has the duty of a fiduciary toward a client.").

241. For example, the AMEX class action was filed in Minnesota, which, in addition to being the domicile state of one defendant (IDS Life Insurance Company, a subsidiary of American Express), was a state that had adopted "shingle theory" legislation for the protection of consumers. 2002 MINN. STAT. § 45.026.

242. *Lander*, 251 F.3d at 110.

243. Under ERISA, an employee benefit plan and pension plan is defined as:

professionals who are responsible for the management and administration of employee benefit plans, including pension plans and related investment vehicles.²⁴⁴ Under ERISA plan administrators are fiduciaries charged with providing employees with information they need to understand their options and to make effective decisions.²⁴⁵ The duties of a fiduciary under ERISA are modeled on fiduciary duties in the law of trusts.²⁴⁶ According to the United States Supreme Court, "ERISA abounds with the language and terminology of trust law . . . ERISA's legislative history confirms that the Act's fiduciary responsibility provisions . . . 'codify] and mak[e] applicable to [ERISA] fiduciaries certain principles developed in the evolution of the law of trusts.'"²⁴⁷

The Restatement (Second) of Trusts,²⁴⁸ in setting out a trustee's duty to furnish information, states that a trustee has "a duty to communicate to the beneficiary all material facts in connection with the transaction which the trustee knows or should know."²⁴⁹ The Restatement further provides that the trustee must "communicate to the beneficiary material facts affecting the interest of the beneficiary which he knows the

any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program—(i) provides retirement income to employees, or (ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond, regardless of the method of calculating the contribution made to the plan, the method of calculating the benefits under the plan or the method of distributing benefits from the plan.

ERISA, 29 U.S.C. § 1002(2)(A) (1994).

244. Plan administrators may be employees working on site at the firm or organization or may be an outside consultant employed as an agent by multiple firms.

245. See ERISA, 29 U.S.C. §§ 1001-1461 (2000). Under ERISA:

a person is a fiduciary with respect to [an employee benefit] plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or . . . disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.

29 U.S.C. § 1002(21)(A).

246. See, e.g., Lorraine A. Schmall, *Telling The Truth About Golden Handshakes: Exit Incentives and Fiduciary Duties*, 5 EMPL. RTS. & EMPLOY. POL'Y J. 169; Maria Hylton & Lorraine Schmall, *Employee Benefits* 318-20 (1998); Ryan P. Barry, *Comment, ERISA's Purpose: The Conveyance of Information from Trustee to Beneficiary*, 31 CONN. L. REV. 735, 746 (1999).

247. *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 110 (1989) (quoting H.R. REP. NO. 93-533, at 11 (1973)).

248. RESTATEMENT (SECOND) OF TRUSTS § 173.

249. *Id.* comment d.

beneficiary does not know and which the beneficiary needs to know for his protection in dealing with a third person with respect to his interest.”²⁵⁰

By enacting ERISA, Congress codified the standards embodied in the law of trusts, requiring in section 1104 that:

a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and— (A) for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries. . . (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.²⁵¹

In addition ERISA mandates that a fiduciary shall not “in his individual or any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries.”²⁵² As is the case in any situation involving a fiduciary, the real question is fact based: What is the content of the fiduciary duty? What must the advisor do in his capacity as fiduciary?²⁵³

3. What the Fiduciary Duty Ought to Require. In the case of an employee asking whether he should invest his 401(k) money in a variable annuity, a plan administrator fulfilling his fiduciary duty would be obliged to inform the employee that an option to place his 401(k) money into a variable annuity is probably not a good choice. At a minimum, the plan administrator, understanding the requirement to communicate the information required for the employee to make the best decision, must explain that there is no additional value to be gained from a second layer of tax deferral (it’s overlapping, not serial). The plan administrator would also have to explain that the functional equivalent would be to invest in mutual funds and then, if desired, purchase an immediate annuity upon retirement. Noting that these two approaches are not one hundred percent congruous, the advisor should go on to explain the additional characteristics of variable annuities, fully

250. *Id.*

251. ERISA, 29 U.S.C. § 1104(a)(1) (2000).

252. ERISA, 29 U.S.C. § 1106(b)(2) (2000).

253. The familiar refrain that a finding of a fiduciary duty is only the beginning of the inquiry applies here. Of course, there is no universally applicable description of the actual content of the duty; it differs depending on the circumstances of the relationship. Shibboleths such as “duty of utmost care” and “something stricter than the morals of the marketplace” only provide a framework for examining the facts of a particular transaction.

educating the beneficiary about the guaranteed death benefit and its potential value or lack thereof. To fully discharge his duties, the advisor would also explain that the annual fees and charges, as well as any surrender charges, would eat into the value of the investment, eroding the funds in the account year by year.

Financial advisors and others licensed to sell variable annuities ought to be held to a heightened duty of disclosure, akin to the duty of a fiduciary. The industry standard on the disclosure required is insufficient in that it is based upon *revelation*, and not *explanation* of information.²⁵⁴ It is not enough to say that the agent has fully explained the product and disclosed the fees, charges, and commissions. Rather, the purveyors of annuities should be required to explain to buyers that the retirement planning objectives accomplished by a variable annuity can be achieved by purchasing mutual funds today and immediate annuities upon retirement. Further, agents must offer a comparison of the expenses associated with variable annuities versus those associated with mutual funds and immediate annuities. Such a comparison would require agents to prepare comparative illustrations showing how the costs will eat into the account balances from year to year. Only then will investors planning for retirement be sufficiently informed to make the decision that is in their best interests: whether the death benefit is worthwhile, whether the loss of liquidity is a meaningful detriment, or whether the simplicity of one-stop shopping is worth the costs involved. If the answer to these questions is yes, then the insurers and their agents will turn a handsome profit for the benefit they confer. If not, the insurers and agents can make an appropriate profit on the sale of a more suitable investment product.

Scrupulous industry actors, from the highest executive levels all the way to street-level financial planners, recognize that the mainstream variable annuity inside a qualified plan is a bad deal. Indeed the president of Nationwide Financial Services Inc. has noted that "there are abuses. . . . I think in the future you'll find that some companies are going to have problems based on the way they sold these variable annuities."²⁵⁵ Inflated sales commissions for variable annuities (up to seven percent, often more than twice the commission for sales of mutual funds) are among the concerns that make many principled financial advisors uncomfortable.²⁵⁶ One accountant and financial planner confessed that variable annuities are a specialized product not appropri-

254. See *supra* notes 186-99 and accompanying text.

255. Bridget O'Brian, *Annuities Watch: Annuities Industry Attempts to Shake Its Bad-Dog Image*, WALL ST. J., Feb. 2, 1998, at C1.

256. *Id.*

ate for the masses.²⁵⁷ As Lou Barberini, a San Francisco accountant and financial planner noted, “[i]t’s a niche product, for someone with a lot of income. . . . That’s the only market I really see for it. . . . The commission is so camouflaged that it’s not apparent to people. . . . I’ve never found anyone it really works for.”²⁵⁸

But most annuities sold into qualified plans result from aggressive selling tactics. “I don’t know anybody who would say it’s good to have a variable annuity inside a qualified plan, other than the people that sell them,”²⁵⁹ said one New York-based insurance consultant whose compensation is fee based, rather than commission driven. Variable annuities are mainly “for unsophisticated people who are talked into things by insurance agents and by brokers and by banks.”²⁶⁰

The practices of the most conscientious annuities companies are instructive. The market conduct of TIAA-CREF highlights what is wrong with the practices of the mainstream life insurers. TIAA-CREF sells more variable annuities than any other firm, and almost all of them go into qualified plans. As an organization that sells variable annuities on a non-profit basis, TIAA-CREF’s fee structure²⁶¹ reveals that the fees charged by most other insurers are not necessary to defray the cost of the death benefit guarantee, as some have claimed in defense of the insurance industry.²⁶²

Were it not for the Uniform Standards Act’s preemption of the annuities cases, the courts would have had an opportunity to address a fraudulent commercial practice about which there was substantial consensus by knowledgeable professionals. In view of the expansion of fiduciary law in recent decades and changes in retirement investment needs of average Americans, it seems likely that the courts would have been sympathetic to those claims.

V. EPILOGUE: CONTINUING SHENANIGANS

One need not look far for reasons to be suspicious of the behavior of insurance companies in the marketplace. The public image of insurance

257. *Id.*

258. *Id.*

259. Franecki, *supra* note 183, at C20 (quoting insurance consultant Glenn Daily).

260. David Franecki, *For Annuities, Past Quarter Brought Assaults on the Industry’s Image, Fees and Tax Status*, WALL ST. J., Apr. 6, 1998, at R28 (quoting insurance consultant Glenn Daily).

261. See Milevsky & Posner, *supra* note 122.

262. See Norse N. Blazzard & Judith A. Hasenauer, *Annuities Are Good for Tax-Qualified Retirement Plans*, NAT’L UNDERWRITER, LIFE & HEALTH/FIN. SERVICES EDITION, Apr. 7, 2003, at 14 (arguing in favor of industry practices).

companies has been bruised by a history of behavior that is, to put it kindly, hard for the public to swallow. Of course, most people recognize the existential conflict insurance companies face. To maximize their profits, they must aggressively induce consumers to purchase policies that will provide benefits in case of certain contingencies and then restrict the payment of benefits when the contingencies occur.²⁶³ This unfortunate reality is widely understood and is not the subject of this Article.

Nevertheless, the annuities class actions arose just as an earlier round of class actions against the insurance industry was winding up. These "market conduct" cases concerned some pretty egregious behavior by insurers.²⁶⁴ Chief among the frauds in these suits were churning practices, in which agents directed customers to move funds from one policy to another for no apparent reason other than the additional

263. In the wake of an earlier round of class action litigation against the insurance industry for fraudulent sales and marketing practices, the industry established a watchdog organization to create guidelines for insurers to help them maintain ethical standards. For a fee, insurers undergo a review of the procedures and policies they have in place regarding training and sales and marketing in the life insurance trade. The Insurance Marketplace Standards Association (IMSA), launched in November 1996, established six Principles of Ethical Market Conduct: (1) to do business according to high standards of honesty and fairness; (2) to provide competent and customer-focused sales and service; (3) to engage in active and fair competition; (4) to provide advertising and sales materials that are clear, honest and fair; (5) to provide fair and expeditious handling of customer complaints and disputes; and (6) to maintain a system of supervision designed to achieve compliance with these principles. Companies that successfully complete the ethics review receive an IMSA seal of approval with which they can certify their clean hands to the investing public. See *US Watchdog Follows Sales Scandals*, LIFE INS. INT'L, Oct. 1996, at 6. It is interesting to note that the IMSA regime is limited to the sales and marketing of annuities and individual life products and was not designed to apply to other contentious areas of the insurance business such as underwriting and payment of claims. See Carole King, *Will IMSA's One-Size-Fits-All Approach Work? Insurance Marketing Standards Assn.'s Certification Program for Life Insurers*, NAT'L UNDERWRITER LIFE & HEALTH/FIN. SERVICES EDITION, Nov. 17, 1997, at 39. IMSA's self-description on its homepage bears this observation: "IMSA is a voluntary membership organization leading the insurance industry in promoting high ethical standards in the sale of individual insurance, long-term care insurance and annuity products." (emphasis added) IMSA, <http://imsaethics.org>. (last visited Jan. 14, 2001).

264. See, e.g., Linda Koco, *Bring the Whole Tribe into Compliance Process*, NAT'L UNDERWRITER, LIFE & HEALTH/FIN. SERVICES EDITION, Jan. 26, 1998, at 19 (noting that concerns about market conduct, namely sales and marketing principles and practices "are but a small component of the overall issue of compliance that insurance companies must confront").

commissions garnered by the brokers, and the “vanishing premiums” scandal.²⁶⁵

Vanishing premiums was the promise made to purchasers of variable life insurance policies who were told they would only have to pay premiums for a relatively short period of time.²⁶⁶ After that time, the investment earnings generated by the paid-in premiums would be sufficient to pay all future premiums—the premiums would vanish.²⁶⁷ As it turned out, the premiums did not disappear and millions of policy holders sued. These practices were costly to consumers and ultimately to the insurers, who were forced to settle the class actions at great expense.

Not only did these settlements involve huge dollar figures, they also affected millions of consumers. State Farm Life Insurance agreed to a settlement of approximately \$200 million with 4.4 million policyholders.²⁶⁸ In 1997 Prudential Financial Services, Inc. set aside \$2.6 billion to pay the claims of 1.1 million policyholders arising from its market conduct litigation.²⁶⁹ Metropolitan Life Insurance Co. settled its market conduct and annuities cases for \$1.7 billion, and it also paid \$109.5 million to settle with state insurance departments and a \$25 million civil penalty to settle a federal investigation.²⁷⁰ John Hancock Mutual Life Insurance settled its cases for \$350 million.²⁷¹

As the vanishing premium litigation drew to a close, the annuities actions were filed and they sometimes included other charges of misdeeds involving “clone funds.”²⁷² As mentioned above, when an investor purchases a variable annuity, he must choose how his premiums will be invested during the accumulation phase. During the late 1990s, when watching the stock markets soar became a national obsession, the highest performing mutual funds gained renown while the fund managers who designed them reaped untold riches and an odd sort of celebrity. With vast sums pouring into these name brand mutual funds like Twentieth Century International Fund, life insurance

265. See Albert B. Crenshaw, *MetLife Agrees to Settle Policy Suits*, WASH. POST, Aug. 19, 1999, at E1.

266. *Id.*

267. *Id.*

268. David Shook, *Fraud Suits Making Life Difficult for Insurers*, THE RECORD (New Jersey), Dec. 13, 1998, at B1.

269. Joseph B. Treaster, *Variable Annuities Inquiry Is Looking into Prudential*, N.Y. TIMES, May 31, 2003, at C2; Shook, *supra* note 268.

270. Treaster, *supra* note 269, at C2; Shook, *supra* note 268.

271. Shook, *supra* note 268.

272. David Frannecki, *Annuity Clones of Mutual Funds Warned*, WALL ST. J., May 26, 1998, at C22.

companies sought to attract capital by naming their own subaccounts after the much adulated mutual funds and replicating their composition.²⁷³ But while the insurance companies were successful in inducing consumers to put their money into these clone funds, the clone funds frequently did not provide the returns achieved by the name brand mutual funds. One plaintiff sued when his "TCI Growth Fund," a clone of the Twentieth Century Growth Fund, suffered a loss of more than five percent while its namesake grew by fifteen percent during the same period.²⁷⁴

Plaintiff in *Young v. Nationwide Life Insurance Co.*²⁷⁵ found a court sympathetic to his claims that he had been defrauded by the insurer's marketing of clone funds.²⁷⁶ In an opinion denying defendant's motion to dismiss,²⁷⁷ Judge Kent of the U.S. District Court in Galveston, Texas, wrote that the practice of giving these subaccounts similar names gives rise to great confusion as to whether the insurance funds are clones: "Defendants should have known that their representations of the funds to be the 'Best of America' and their use of nearly identical monikers, posed a danger of misleading investors."²⁷⁸ Judge Kent continued, noting that "an inference rises that they were attempting to associate the insurance funds with the retail funds, despite the fact that the two in fact did not correlate, in order to capitalize on the popularity of the well known publicly traded mutual funds with the same name."²⁷⁹ While these claims never amounted to much, they are yet another reminder that wholesale legislative initiatives to hamstring the judicial process can leave consumers in a very vulnerable position.

Recently there have been new charges, though not well documented, that insurance agents have been "mishandling" sales documents and continuing to make unsuitable sales of variable annuities.²⁸⁰ Indeed

273. "Clone fund" is something of a misnomer, as there are usually differences in the composition, cash flows, and expenses of the original and the clone. These differences can add up to a substantial disparity in performance, as in the case of the Hartford Capital Appreciation fund which, during a twelve-month period in the late 1990's, grew by one hundred percent, while its clone gained only forty-five percent. See Edward Wyatt, *How a Fund's Clone Can Become a Very Different Animal*, N.Y. TIMES, Aug. 17, 1997, at § 3, p. 8.

274. *Young v. Nationwide Life Ins. Co.*, 2 F. Supp. 2d 914 (S.D. Texas 1998).

275. *Id.* at 919.

276. *Id.* at 922.

277. *Id.* at 930.

278. *Id.* at 922.

279. *Id.*

280. See Treaster, *supra* note 269 (reporting that NASD and the New York State Insurance Department are investigating various "technical violations" in the sales of variable annuities); NASD *News Release*, NASD Takes Disciplinary Action for Variable

new deceptions are likely to be unearthed for the foreseeable future as insurance companies tweak their product lines to remain a step ahead of regulators and consumers. This tinkering frustrates the attempts of the overwhelmed and underresourced state regulators who are charged with overseeing the insurance industry.²⁸¹ Companies are able to get around the regulators by renaming products or subtly changing their features. For example, according to one state regulator, a company “won’t call it an equity indexed annuity, they’ll call it something else and it gets approved.”²⁸² One regulator concluded that there are “too many situations in which promises are made with one hand and taken away with another and we are not regulatorily equipped to deal with that . . . we have to eliminate not-safe-at-any speed types of products.”²⁸³

Insurance companies and other providers of investment products will always look for a competitive edge, staying a step ahead of consumers and the law. And they have a substantial built-in advantage over the consumers. Their advantage comes from the very nature of the insurance business. Because actuarial computation lies at the heart of the risk management process, insurance companies have the ability to price various components of their products with great precision. Costs and profits are measured in basis points. To the average consumer, two or three basis points is a rounding factor, a matter of a few dollars. But when one considers the minute precision with which insurance companies calculate their figures, in combination with the fact that the industry controls hundreds of billions of dollars, those little basis points can add up to staggering amounts of money. Further, decisionmakers within insurance firms, like all corporate executives, have substantial personal financial stakes in the firm’s profits. Therefore, the addition of even one basis point of profit across a ten billion dollar portfolio could amount to a substantial incentive to deceive consumers who might contribute to those profits by investing.

The foregoing catalog of past and emerging misdeeds on the part of the insurance industry should be sufficient to persuade anyone concerned with consumer protection that chicanery is to be expected from insurers.

Annuity Abuses and Issues Investor Alert on Variable Products (May 27, 2003) (announcing \$125,000 fining of Florida affiliate of Western Reserve Life Assurance Co. for mishandling investor complaints about variable annuities and announcing three other enforcement actions against individual agents for unsuitable sales of variable annuities).

281. See Jim Connolly, *Product Innovations Stun Regulators*, NAT’L UNDERWRITER, LIFE & HEALTH/FIN. SERVICES EDITION, Dec. 15, 1997, at 6.

282. *Id.* (quoting Jerry Fickes, life insurance actuary with the New Mexico Department of Insurance).

283. *Id.* (quoting Tom Foley, Chair of the Life & Health Actuarial (Technical) Task Force).

However, to those who believe that market forces and the current legal order impose sufficient restraints, there is one bit of statistical evidence suggesting that lawsuits, self-regulatory agency action, SEC regulatory oversight, industry watchdog activity, and congressional reformation of securities law have not quite put out the fire. Logic and a reasonably optimistic view of human nature would suggest that after all the attention paid to the sales of variable annuities in qualified plans, an analysis of cold, hard data would reveal that companies are no longer selling variable annuities into qualified plans. One would expect to see a significant drop off beginning around 1999 when the class action lawyers really sank their teeth into the matter and sent their associates digging deeply into the confidential documents of the defendant companies. One would hope, in any event, to find statistics on sales of annuities into qualified plans, but such data is closely guarded by the industry and is not normally disclosed. However, a report obtained from the Life Insurance Market Research Association (LIMRA) tells an interesting story. A glance at Table 3 reveals a rather alarming trend.

Inexplicably, the percentage of annuities being sold into qualified plans has actually increased since 1998, the year the class actions were filed and the companies were put on notice that the world was watching. It is difficult to understand exactly why the insurance industry has not curtailed these abusive sales practices.²⁸⁴ Perhaps it is not farfetched to surmise that once the federal appellate courts began dismissing the annuities class actions on the grounds of Uniform Standards Act preemption, the insurance companies heaved a sigh of relief and went back to business as usual. With the percentage of variable annuities sold into qualified plans at its highest level since overall variable annuity sales exploded in the early 1990s, one is left with the conclusion that the “reforms” implemented as part of the Contract with America,

284. One partial explanation for the continued high levels of qualified annuities sales comes from the experience of TIAA-CREF. TIAA-CREF originated the variable annuity in 1951 and is the leading U.S. seller. TIAA-CREF sells a large volume of variable annuities into qualified plans both to its members (teachers and other university employees) and to the public. TIAA-CREF's market share in 2001 was approximately twenty-eight percent for new variable annuities contracts. See Rick Carey, *First Quarter VA Sales of \$2.6 Billion Lag Behind Last Year's Pace*, NAT'L UNDERWRITER, LIFE & HEALTH/FIN. SERVICES EDITION, June 10, 2002, at 23. However, as a nonprofit institution, CREF sells these products in a consumer-friendly manner, with extremely low fees and charges. The annuities sold directly to the public are not sold through broker-dealers and so sales commissions, a major component of the costs that make variable annuities an unsuitable investment for qualified plans, are not involved. *Id.* Nevertheless, even excluding TIAA-CREF annuities from the industry figures, the lack of any appreciable overall drop in the percentage of all variable annuity sales that are qualified sales indicates the dramatic drop off one would have expected.

TABLE 3

Year	Total VA Sales (in billions)	VA Sales into Qualified Plans	Percentage of VA Sales in QP
1985	\$5.29	\$4.6	87%
1986	\$9.30	\$7.4	80%
1987	\$12.70	\$10.3	81%
1988	\$11.80	\$9.8	83%
1989	\$13.50	\$10.8	80%
1990	\$17.20	\$13.2	77%
1991	\$21.50	\$15.9	74%
1992	\$30.70	\$20.8	68%
1993	\$47.00	\$26.0	55%
1994	\$51.70	\$30.0	58%
1995	\$49.50	\$29.3	59%
1996	\$72.80	\$39.9	55%
1997	\$87.90	\$48.2	55%
1998	\$99.50	\$54.4	55%
1999	\$121.80	\$68.0	56%
2000	\$137.20	\$74.7	54%
2001	\$111.00	\$61.3	55%
2002*	\$119.30	\$69.9	59%

* Preliminary estimate

Note: Dollar figures are in billions. Qualified sales includes all types of IRAs, 403(b), 401(k), Keogh, Pension trust, and deferred compensation programs in which money deposited qualifies for federal income tax deferral under IRS code.

Source: LIMRA International

which were sold by Congress as a way to improve corporate disclosure, have had quite the opposite effect in this particular instance. Insulated by securities reform legislation from the disciplinary effect of class actions, it seems as though life insurance companies will continue to aggressively push retirement investors to purchase variable annuities for their tax-qualified plans.

CONCLUSION

In an ideal world, all legislation would be drafted to efficiently address the problems that a strong majority agrees merit attention. In this best of all possible worlds, our elected officials frequently come up short. The likelihood of this occurring is predictably greater when Congress rushes into dramatic reforms, rather than pursuing incremental steps in a more deliberate fashion. Because the Reform Act's definition of "covered security" was not sufficiently considered, a huge class of Americans have been locked out of court, unable to pursue a remedy for a widespread and shameless fraud. The one-two punch of PSLRA and SLUSA ended up being a knockout for the annuities plaintiffs.

In an era when reliance on corporate and governmental old age assistance is increasingly in doubt, it is more important than ever that Americans maximize their capacity to be self-sufficient in retirement. As the baby boom generation reaches retirement age, fewer and fewer workers will be paying benefits into an already ailing Social Security system to fund the benefits of more and more retirees.²⁸⁵ Apart from the demographic trends, political momentum in Washington seems to be steering Social Security away from its traditional paternalistic structure and toward a model based on individual accounts. Beyond the distributive injustices this shift is likely to cause, a move to individual accounts will no doubt place a huge burden on individuals in terms of their ability to wisely handle investment decisions and interactions with investment professionals. If this nation is to experience an unprecedented transfer of government-managed retirement assets into private hands, it would be wise to allow the courts to confront the power disparities that exist between investors and their advisors.

The Social Security Trust Fund currently contains \$1.4 trillion in assets.²⁸⁶ To prevent financial services professionals from taking more

285. See Fanto, *supra* note 178. The worker to retiree ratio has fallen from 16 to 1 in 1950 to its current level of 3.3 to 1. By 2040, the ratio will be 2 to 1, a level insufficient to fulfill current promises while maintaining current taxation levels. See Social Security Administration, *Frequently Asked Questions About Social Security's Future*, available at <http://www.ssa.gov/qa.htm>.

286. Social Security Administration, at <http://www.ssa.gov/qa.htm>.

than their fair share of this fortune in the coming decades, the legal system must be able to respond energetically to aggressive sales practices like the ones detailed in this Article. The annuities litigation provided an opportunity for reform. Unfortunately because Congress was in such a hurry to enact a different kind of reform, the judicial process was incapacitated. One hopes that Congress can learn a lesson from this episode and perhaps loosen the strictures it has imposed on a litigation system that, for all its warts, is an important mechanism for checking the excesses of the market.
