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Cultivating Pension Plans

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Cultivating Pension Plans

Abstract

Federal law both cultivates and regulates employer-sponsored pension plans in the United States. Some believe that because employers have been migrating away from traditional defined benefit pension plans in the United States, the plan cultivation provisions of federal law have failed to encourage U.S. employers to offer pension benefits to their employees. However, Congress has allowed each employer to decide for itself whether to provide pension benefits to its employees and, if so, what kind of pension benefits to provide. Employers appear to have migrated away from traditional defined benefit plans primarily because employers have concluded that defined contribution plans and some hybrid plans are more compatible with their own interests and the interests of their employees than are traditional defined benefit plans.

Keywords

Code, cultivation, defined benefit, defined contribution, ERISA, migration, pension, regulation, self-defeating, voluntary.

Disciplines

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Reimagining Pensions

The Next 40 Years

EDITED BY

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Chapter 11

Cultivating Pension Plans

John M. Vine

The Internal Revenue Code (the Code) and the Employee Retirement Income Security Act (ERISA) cultivate employer-sponsored pension plans in the United States. The former does this by offering advantageous tax treatment to tax-qualified pension plans, plan sponsors, and participating employees and their beneficiaries; and the latter by facilitating employer administration of employer-sponsored pension plans. Nevertheless, the Code and ERISA do not merely cultivate employer-sponsored pension plans: they also regulate employer-sponsored pension plans. In order for an employer-sponsored pension plan to be tax-qualified and to be eligible for the tax advantages that flow from tax-qualification, the plan must meet regulatory requirements imposed by the Code. Similarly, although ERISA does not require an employer to maintain a pension plan, ERISA requires any pension plan that an employer adopts to meet ERISA's regulatory requirements.

Some believe that the cultivation provisions and the regulatory provisions are colliding. One reason for this belief is theoretical: regulatory requirements, standing by themselves, can discourage employers from sponsoring pension plans, prevent employees from earning pension benefits, and thereby defeat the objectives of the plan cultivation provisions. Another reason for this belief is empirical: corporate employers in the United States have been migrating away from defined benefit (DB) plans for the past 30 years. Since the mid-1980s, relatively few new DB plans have been established in the private sector, and many previously established DB plans in the private sector have been closed to new hires, amended to halt the accrual of benefits for some or all employees (that is, 'frozen'), or terminated. In addition, some DB plans in the private sector have transferred a portion of their liabilities to insurers. Increasingly, corporate employers have chosen to provide pension benefits exclusively through defined contribution (DC) plans (EBSA 2013).

Employers have migrated away from traditional DB plans for a variety of reasons. Employers have sought, among other things, to avoid the volatile pension expenses that DB plans impose on employers that sponsor DB

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plans, to provide pension benefits that employees understand, and to provide pension benefits that employees value more highly than the benefits provided by traditional DB plans. In addition, employers have sought to allocate pension benefits among participating employees more evenly than do many traditional DB plans, to reduce the risk of class action litigation challenging the design or administration of DB plans, and to avoid the need to comply with the regulatory requirements imposed on DB plans by the Code and ERISA. Also, due to the increasingly severe limits that the Code imposes on the benefits that a tax-qualified plan may provide, nonqualified plans have become responsible for an increasing share of the retirement benefits of corporate executives. As a result, top corporate executives have grown less reluctant to approve proposals to close, freeze, or terminate broad-based tax-qualified DB plans in which the top executives have a relatively small personal stake.

Notwithstanding the migration of corporate employers away from DB plans, the plan cultivation provisions in the Code and ERISA appear to have encouraged employers to establish and maintain DC plans. This suggests that, far from being stymied by the regulatory provisions, the plan cultivation provisions have succeeded in promoting the growth of DC plans. After all, these provisions are designed to allow each employer to determine what (if any) benefit plans it will adopt and what benefits it will provide, based on its assessment of what plans and benefits are in its own and its employees' best interests. It appears that, for a variety of reasons, many employers now believe that DC plans do a better job of meeting both their needs and their employees' needs than do DB plans.

Before ERISA

Federal Tax Laws

Before the enactment of ERISA in 1974, corporate pension plans in the United States were regulated principally by the federal tax laws. In general, an employer was free to decide whether to sponsor a pension plan, to determine the benefits that the plan would provide, and to establish the terms on which benefits would be provided, subject to the employer's collective bargaining obligations, if any.

Since the very early days of the federal income tax, the federal tax laws have granted favorable tax treatment to tax-qualified plans. The Revenue Act of 1921 conferred tax-exempt status on a trust that was part of an employer's stock bonus or profit sharing plan for 'some or all of [the employer's] employees' (Revenue Act of 1921: §219(f)). In 1926, this provision was expanded to include pension plans (Revenue Act of 1926: §219(f)).

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The US Treasury, however, became dissatisfied with the 1921 Act's 'some or all' coverage standard. In 1937, the Treasury informed Congress that, although the Code's pension provisions had been intended to 'encourage pension trusts for aged employees,' the pension provisions had been 'twisted into a means of tax avoidance by the creation of pension trusts' covering 'only small groups of officers and directors who are in the high income brackets.' The Treasury proposed replacing the 'some or all' coverage standard with a requirement that a qualified pension plan cover a 'reasonable number' of employees (US Congress 1937: 294).

Congress did not act on the Treasury's 1937 proposal, however, and in 1942 the Treasury presented Congress with a revised proposal that gave greater emphasis to the objective of covering rank-and-file employees:

The present treatment of pension trusts affords a tax subsidy to those trusts which meet the requirements set forth in the statute. This subsidy is at the expense of the general body of taxpayers. It was granted because of the desire to improve the welfare of employees by encouraging the establishment of pension trusts for their benefit. Our purpose in presenting our suggestions was to carry out this objective of the Congress by suggesting various provisions which would both make the present statute more effective in promoting the welfare of employees through such trusts and at the same time prevent utilization of such trusts for tax-avoidance purposes. (US Treasury 1942: 2405–6)

Congress responded favorably to this proposal, passing the Revenue Act of 1942 which required a tax-qualified plan to benefit either (1) at least 70 percent of all employees (or at least 80 percent of all eligible employees if at least 70 percent of all employees were eligible) or (2) employees who qualified under a classification established by the employer and found by the Commissioner of Internal Revenue not to discriminate in favor of employees who were officers, shareholders, supervisors, or highly compensated employees (the prohibited group). The 1942 Act also provided that a plan would not be treated as tax-qualified unless the contributions or benefits under the plan did not discriminate in favor of employees who were members of the prohibited group. The House Ways and Means Committee explained that the new requirements were designed 'to insure that [tax-qualified] plans are operated for the welfare of employees in general, and to prevent the trust device from being used for the benefit of shareholders, officials [*sic*], or highly-paid employees' (H.R. Rep. No. 2333 1942: 103–4).

The pre-ERISA version of the Code provided tax rules that encouraged employers to maintain tax-qualified pension plans. The tax rules governing tax-qualified plans provided for current deductibility (within limits) of employer contributions, deferred recognition of income by plan participants, and a tax-exemption for the plan itself. Participants in tax-qualified

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plans also received advantageous tax treatment for certain plan distributions. For example, the Code treated the income that was included in a lump-sum distribution from a plan as long-term capital gain rather than as ordinary income. Also, a participant who received a distribution of appreciated employer securities in a lump-sum distribution from a tax-qualified plan could exclude the appreciation from income until the securities were sold.

Before the enactment of ERISA, some employers provided pension benefits for both upper echelon and rank-and-file employees on an unfunded, pay-as-you-go basis, rather than through a funded, tax-qualified plan. Because an unfunded plan did not allow an employer to claim up-front deductions for its contributions to the plan, was not funded by a tax-exempt trust, and was not subject to the special rules for plan distributions, an unfunded plan was less tax-effective than a tax-qualified plan. The Internal Revenue Service's position at the time was that an unfunded plan could not be tax-qualified (Rev. Rul. 71-91 1971).

The Code did not require a pension plan to comply with the Code's tax-qualification requirements. However, if an employer wished to maintain a funded pension plan in which employees had vested interests, a tax-qualified plan was usually the most advantageous option. The Tax Reform Act of 1969 made it particularly unattractive for an employee to have a vested interest in a nonqualified, funded deferred compensation plan: the employee was required to include the value of his or her vested benefits in income before the plan distributed the benefits to the employee (Joint Committee 1970).

Other laws

Before the enactment of ERISA, no federal law comprehensively regulated pension plans. The Welfare and Pension Plans Disclosure Act (WPPDA) imposed only modest disclosure requirements and, at least until 1962, the WPPDA relied solely on individual employees for enforcement. The Labor-Management Relations Act applied only to employee benefit funds that were administered jointly by employers and unions. Although criminal penalties applied to theft, embezzlement, and bribery involving employee benefit plans, criminal penalties were not effective in curbing benefit plan abuses (H.R. Rep. No. 533 1973; S. Rep. No. 127 1973).

A few states also had enacted laws specifically designed to regulate the administration of employee benefit plans, but these state laws were not uniform. Moreover, although the state-law rules were generally based on the common law of trusts, it was unclear whether the common law of trusts applied to plans that were not funded by traditional trust arrangements. In

any event, individual states did not appear to be up to the task of adequately protecting the interests of plan participants and beneficiaries in multi-state benefit plans (H.R. Rep. No. 533 1973; S. Rep. No. 127 1973; Bureau of National Affairs 1962).

The Prologue to ERISA

In 1962, President Kennedy called for a review of the rules governing the tax treatment and investment policies of corporate pension funds and private retirement programs, and created a Cabinet-level committee (the Committee) to review the implications of the growing array of retirement and welfare funds. The Committee was called the President's Committee on Corporate Pension Funds and Other Private Retirement and Welfare Programs, and the members of the Committee were the Secretary of Labor, the Secretary of the Treasury, the Secretary of Health, Education, and Welfare, the Director of the Bureau of the Budget, the Chairman of the Council of Economic Advisers, the Chairman of the Board of Governors of the Federal Reserve System, and the Chairman of the Securities and Exchange Commission.

The Committee's Report, issued in 1965, observed that Congress had long recognized both 'the importance of stimulating the development of private retirement plans' and 'the growing importance of establishing standards and regulations' to assure that the plans serve the public interest (President's Committee 1965: 18). The Report concluded that 'public policy should continue to provide appropriate incentives to private plan growth' and, by improving the plans' soundness and equitable character, 'set a firmer foundation for their future development' (President's Committee 1965: 25).

The Report also emphasized two aspects of the tax treatment of tax-qualified plans. The first was the mismatch between the immediate deductibility of employer contributions to the plan and the deferred recognition of income by participants until they received distributions from the plan. The second was the tax-exempt status of the plan itself. The Report concluded that taxpayers were indirectly subsidizing pension plans, and observed that, without the advantageous tax treatment of qualified pension plans, employees and employers would have to contribute far more if they wished to maintain the current level of pension benefits (President's Committee 1965).

The Report set the stage for a decade-long study of private pension plans that culminated in the enactment of ERISA in 1974. The Report recommended several steps including legislation governing such subjects as participation, vesting, funding, coverage, nondiscrimination, disclosure, limits

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on benefits and contributions, and limits on investments in employer securities. The Report also proposed repeal of the rules giving favorable tax treatment to lump-sum distributions and to distributions of appreciated employer securities, and recommended study of a number of other subjects, including pension portability and termination insurance (President's Committee 1965).

Although the Report was very influential, additional interest in pension reform was stimulated by other events, including evidence of corruption in the administration of multiemployer plans that emerged from Congressional investigations during the early 1950s, and the termination of the Studebaker pension plan in 1963, which caused over 4,000 workers with vested pension rights to lose some or all of their benefits (H.R. Rep. No. 533 1973; S. Rep. No. 127 1973; Wooten 2004: 73–8).

ERISA

Enacted in 1974, ERISA was designed to protect participants' interests in pension plans, not to require employers to maintain pension plans. ERISA regulated pensions by imposing minimum standards on plans (covering such matters as participation, vesting, benefit distribution, and funding), by requiring most DB plans to participate in a national plan termination insurance program, and by subjecting pension plans to reporting and disclosure, fiduciary responsibility, and enforcement provisions.

Congress was concerned, however, that regulatory provisions could do more harm than good. Congress recognized that regulatory provisions would protect employees only if employers elected to maintain pension plans for them and that employers' willingness to maintain pension plans voluntarily could not be taken for granted. Regulatory provisions could discourage employers from adopting pension plans, encourage employers to terminate existing plans, or both, reducing the number of plans, the number of covered employees, and the value of the benefits the plans would distribute. To counteract the potentially self-defeating consequences of ERISA's regulatory provisions, Congress included in ERISA provisions that were designed to cultivate pension plans. A leading account of ERISA's enactment concluded that 'Congress chose less stringent measures than it might have because legislators believed that stricter regulation would overburden plan sponsors . . . Protective measures increase costs, which may lead employers to shut down a plan or reduce benefits' (Wooten 2004: 272).

In order to encourage employers to award their employees enforceable pension rights under voluntary employer-provided pension plans, Congress sought to strike a balance between plan cultivation and plan regulation. The United States Supreme Court (the Supreme Court) later observed that:

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ERISA represents a careful balancing between ensuring fair and prompt enforcement of rights under a plan and the encouragement of the creation of such plans. Congress sought to create a system that is [not] so complex that administrative costs, or litigation expenses, unduly discourage employers from offering [ERISA] plans in the first place. (*Conkright v. Frommert* 2010: 517)

Each of the four Senate and House committees responsible for the bills that became ERISA expressed its intent to foster the establishment and growth of voluntary employer-sponsored plans. (Pertinent portions of the committee reports are set forth in Appendix Table 11.A1.)

The statement of purpose in Title IV of ERISA (Plan Termination Insurance) formally proclaimed Congress's intent to cultivate pension plans:

The purposes of this title, which are to be carried out by the [Pension Benefit Guaranty Corporation], are—(1) to encourage the continuation and maintenance of voluntary private pension plans for the benefit of their participants,

(2) to provide for the timely and uninterrupted payment of pension benefits to participants and beneficiaries under plans to which this title applies, and

(3) to maintain premiums established by the [PBGC] under section 4006 at the lowest level consistent with carrying out its obligations under this title. (ERISA §4002(a))

Congress's intent was also carried out by the ERISA provisions governing plan management and administration, employer securities, vesting, and preemption.

Plan management and administration

ERISA requires every employee benefit plan to be established and maintained pursuant to a written instrument that (1) provides a procedure for establishing and carrying out a funding policy and method that is consistent with the plan's objectives and ERISA's requirements; (2) describes any procedure under the plan for allocating administrative responsibilities; (3) provides a procedure for amending the plan; and (4) specifies the basis on which payments are made to and from the plan. ERISA also requires plan fiduciaries to discharge their duties in accordance with the plan's governing documents and instruments insofar as they are consistent with Titles I and IV of ERISA. Finally, ERISA permits a plan participant or beneficiary to bring a civil action to recover benefits due under the terms of the plan, to enforce his or her rights under the terms of the plan, or to clarify his or her rights to benefits under the terms of the plan (ERISA §§402(b), 502(a)).

These provisions both regulate and cultivate employee benefit plans. Because of these provisions, employees can ascertain their benefits, can enforce their benefit rights, and are protected from claims that unwritten

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amendments have eliminated their benefit rights under the plan. As the United States Court of Appeals for the Third Circuit observed,

ERISA § 402(a)(1) was designed to ensure that every employee may, on examining the plan documents, determine exactly what his rights and obligations are under the plan. Employees entitled to rely on the terms of a written benefit plan should not have their benefits eroded by oral modifications to the . . . plan. Congress, in passing ERISA, did not intend that participants in employee benefit plans should be left to the uncertainties of oral communications in finding out precisely what rights they were given under their plan. (*Hamilton v. Air Jamaica, Ltd.* 1991: 78–9)

ERISA's plan document provisions also help to provide certainty to plan sponsors and plan administrators: they help to define the employer's financial obligation to the plan, facilitate efficient, reliable, and consistent plan administration, and provide a plan amendment procedure that can be invoked to make changes in the plan. The Supreme Court has stated:

[H]aving an amendment procedure enables plan administrators, the people who manage the plan on a day-to-day level, to have a mechanism for sorting out, from among the occasional corporate communications that pass through their offices and that conflict with the existing plan terms, the bona fide amendments from those that are not. (*Curtiss-Wright Corp. v. Schoonejongen* 1995: 82)

Moreover, ERISA treats the act of amending or terminating a plan as a settlor function rather than as a fiduciary function. ERISA provides that

a person is a fiduciary with respect to a plan to the extent (1) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (2) he renders investment advice for a fee . . . with respect to any moneys or property of such plan . . . , or (3) he has any discretionary authority or discretionary responsibility in the administration of such plan. (ERISA §3(21)(A))

Because ERISA's definition of 'fiduciary' focuses on plan management, plan administration, and investment advice, an employer does not act in a fiduciary capacity, and is not subject to ERISA's fiduciary standards, when it acts as the plan's sponsor or 'settlor,' such as when it decides whether to establish, amend, or terminate a plan. ERISA's definition of 'fiduciary' thus allows employers to design their plans as they see fit, subject only to the substantive requirements of ERISA and without their design decisions being made subject to judicial review for compliance with ERISA's fiduciary standards.

The settlor function doctrine—under which plan design decisions are outside the scope of ERISA's fiduciary responsibility standards—is fundamental to plan cultivation. Employers would undoubtedly be reluctant to adopt employee benefit plans if employers were treated as fiduciaries (and were subject to ERISA's fiduciary standards) when they adopt, amend, or

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terminate a plan and were therefore required, for example, to make design decisions solely in the interest of plan participants. Because the settlor function doctrine recognizes that ERISA's fiduciary standards do not apply to decisions to establish, amend, or terminate a plan, the settlor function doctrine advances the objective of plan cultivation by giving plan sponsors considerable latitude to design plans as they see fit.

The Supreme Court has distinguished plan design decisions (non-fiduciary decisions that ERISA leaves largely to the plan's settlor) from decisions regarding plan management and administration (fiduciary decisions that are governed by ERISA's fiduciary responsibility standards). In *Lockheed Corp. v. Spink* (1996), the Supreme Court ruled that Lockheed did not act in a fiduciary capacity when it amended its pension plan to add an early retirement incentive that was payable to employees who retired early and who released any employment-related claims they might have against Lockheed. The Court emphasized that 'only when fulfilling certain defined functions does a person become a fiduciary' under ERISA and that the functions specified by ERISA's definition of fiduciary 'do not include plan design.' The Court went on to say that 'ERISA leaves th[e] question of the content of benefits to the private parties creating the plan . . . [T]he private parties, not the Government, control the level of benefits' (*Lockheed Corp. v. Spink* 1996: 887–90, 894).

In addition, ERISA's prohibited transaction rules—which bar transactions that Congress deemed potentially abusive—include an exemption that accommodates employer-administered plans. Set forth in ERISA §408(c)(3), the exemption provides that the prohibited transaction rules do not forbid the same person from serving both as a plan fiduciary and as an officer, employee, agent, or other representative of a party in interest (such as the sponsoring employer). The exemption authorizes a significant departure from the prototypical arrangement under the common law of trusts in which the trust is administered by a disinterested fiduciary.¹ Although the §408(c)(3) exemption does not relieve a fiduciary of its obligations under ERISA's general fiduciary standards, such as the duty of prudence, the exemption makes it clear that a fiduciary's status as a representative of the employer does not violate ERISA's prohibited transaction rules.

Employer securities

The President's Committee also called for changes in the treatment of plan investments in employer securities. The Committee concluded that, in assessing investments in employer securities, it was impossible to rely on the same standards of investment judgment that could be expected to

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prevail when a fiduciary made other investments and that investing a large percentage of a plan's assets in a single equity security subjected the plan to inappropriate risks. The Committee recommended a limit of 'perhaps 10 percent' on the portion of a pension plan's assets that could be invested in employer securities (President's Committee 1965: 76).

The Committee also criticized the income tax rules governing appreciated employer securities received in a lump-sum distribution from a tax-qualified plan. Under those rules, any increase in the value of the securities over their cost to the plan was not included in the employee's gross income until the securities were sold. The Committee recommended repeal of those rules on the grounds that (1) only a relatively small percentage of plan participants could take advantage of the rules and (2) the rules artificially encouraged investment in employer securities (President's Committee 1965: 66).

Nevertheless, Congress implemented only some of the Committee's recommendations regarding employer securities. On the one hand, ERISA's fiduciary standards imposed a duty to diversify plan assets, imposed a 10 percent limit on investments in employer securities and employer real property, and curbed self-dealing. On the other hand, ERISA modified these restrictions to accommodate investments in employer securities by eligible individual account plans (EIAPs) and employee stock ownership plans (ESOPs). In general terms, ERISA defined an EIAP as (1) an individual account plan that explicitly provides for the acquisition of employer stock and that is a profit-sharing, stock bonus, thrift, or savings plan, (2) an ESOP, or (3) a money purchase pension plan that was in existence on September 2, 1974, and that on that date invested primarily in employer stock. ERISA defined an ESOP as an individual account plan that is a stock bonus plan, or stock bonus plan and money purchase plan, that is tax-qualified, that is designed to invest primarily in employer stock, and that meets any other requirements imposed by Treasury Department regulations (ERISA §407(d) (3) & (6); Treas. Reg. §54.4975-11; 29 C.F.R. §2550.407d-6).

ERISA exempted EIAPs (including ESOPs) from both ERISA's diversification requirements and its 10 percent limit on the portion of plan assets that may be invested in employer securities. In addition, ERISA exempted an EIAP's purchases and sales of employer securities from ERISA's generally applicable ban on party-in-interest transactions and permitted an ESOP to borrow from the employer in order to invest in employer securities (*White v. Marshall & Ilsley Corp.* 2013).² Moreover, ERISA did not change the income tax treatment of unrealized appreciation on employer securities, as the President's Committee had recommended. Instead, ERISA reduced the disparity between the income tax treatment of distributions of appreciated employer securities and the income tax treatment of other distributions by making many other distributions eligible for tax-free rollover.

Vesting

ERISA's vesting provisions both regulate and cultivate benefit plans. Although ERISA's detailed vesting and benefit accrual requirements are regulatory measures, ERISA's vesting requirements apply to a benefit only if the benefit is classified by ERISA as an accrued benefit (ERISA 203(a)). As a result, many valuable pension benefits, such as early retirement subsidies and disability benefits, are exempted from ERISA's vesting requirements.

ERISA's plan cultivation provisions played a central role in the Supreme Court's 1981 ruling regarding the application of ERISA's vesting provisions to an offset provision in a pension plan's benefit formula (*Alessi v. Raybestos-Manhattan, Inc.* 1981). The offset provision reduced a participant's gross pension benefit by the amount of any workers' compensation payments that the participant was entitled to receive. The Court ruled that the offset did not violate ERISA's vesting standards. According to the Court, the plaintiffs' vesting claim overlooked the fact that the private party creating the plan (the settlor) typically 'defines the content of the benefit that, once vested, cannot be forfeited... Rather than imposing mandatory pension levels or methods for calculating benefits, Congress in ERISA set outer bounds on permissible accrual practices' (*Alessi v. Raybestos-Manhattan, Inc.* 1981: 511–12).

ERISA also cultivated welfare benefits, such as severance benefits and retiree health benefits, by exempting welfare benefits from its vesting and benefit accrual requirements. The welfare benefit exemption was motivated by Congress's concern that the application of the vesting and benefit accrual requirements to welfare benefits would significantly complicate plan administration, increase the cost of providing welfare benefits, and discourage employers from maintaining welfare benefit plans. As the United States Court of Appeals for the Third Circuit observed,

Congress plainly did not impose as stringent vesting requirements as it might have. We can hardly attribute that decision to oversight, however. Having made a fundamental decision not to require employers to provide *any* benefit plans, Congress was forced to balance its desire to regulate extant plans more extensively against the danger that increased regulation would deter employers from creating such plans in the first place. In other words, although ERISA was clearly designed to promote the interests of employees and their beneficiaries in employee benefit plans, the statute was also designed to minimiz[e] the adverse impact of cost increases imposed on employers by the tougher regulation... Congress's concern with minimizing employers' compliance costs is especially evident in ERISA's accrual and vesting provisions. Before determining appropriate minimum vesting requirements for pension plans, the Senate Subcommittee on Labor commissioned an independent actuarial study to determine the range of estimated costs to private pension plans resulting from compliance with minimum vesting requirements under several proposed minimum vesting standards. (*Hozier v. Midwest Fasteners* 1990: 1160; *Gable v. Sweetheart Cup Co.* 1994: 859–60)

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The courts have found that the welfare plan exemption furthered the interests of employees because the knowledge that they could reduce or eliminate welfare benefits made employers more willing to provide those benefits, and because employees remained free to bargain with their employers for the vesting of welfare benefits (*Hamilton v. Air Jamaica, Ltd.* 1991).

Preemption

ERISA's preemption provision states that ERISA 'shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan' (ERISA §514(a)). The Supreme Court has interpreted this provision to advance ERISA's plan cultivation agenda. The Supreme Court observed that '[a] patchwork scheme of regulation would introduce considerable inefficiencies in benefit program operation, which might lead those employers with existing plans to reduce benefits, and those without such plans to refrain from adopting them. Pre-emption assures that the administrative practices of a benefit plan will be governed by only a single set of regulations' (*Fort Halifax v. Coyne* 1987: 11).

For example, in 1987, the Supreme Court considered whether ERISA preempted a Mississippi common-law cause of action alleging improper processing of a benefit claim under an insured employee benefit plan. In ruling that ERISA preempted the Mississippi law, the Court relied on ERISA's comprehensive civil enforcement scheme which, the Court said, 'represents a careful balancing of the need for prompt and fair claims settlement procedures against the public interest in encouraging the formation of employee benefit plans.' The Court concluded that ERISA's enforcement regime would be undermined if a participant were free to obtain remedies under state law that were not available under §502 of ERISA. (*Pilot Life Ins. Co. v. Dedeaux* 1987: 54; *Aetna Health Inc. v. Davila* 2004 (holding that ERISA preempted a Texas cause of action that duplicates or supplements an ERISA cause of action)).

In 1990, the Supreme Court held that ERISA preempted a Texas wrongful discharge statute that had been construed to apply to an employee who allegedly was terminated because the employer sought to avoid making pension contributions on his behalf. Based on ERISA's broad preemption provision and its larger purpose in 'encouraging the formation of employee benefit plans,' the Court ruled that ERISA preempted such state-law claims (*Ingersoll-Rand Co. v. McClendon* 1990: 143–4).

In 2001, the Supreme Court also held that ERISA preempted a State of Washington statute providing that the designation of a spouse as the beneficiary of a nonprobate asset is automatically revoked upon divorce. The

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Court ruled that the Washington statute subverted two key features of ERISA's plan cultivation provisions: the plan document requirement and nationally uniform plan administration (*Egelhoff v. Egelhoff* 2001).

The United States Court of Appeals for the Second Circuit also has invoked ERISA's cultivation objectives to support its ruling that ERISA does *not* preempt malpractice actions against actuaries and other professionals who provided services to employee benefit plans. The court of appeals observed that 'immunizing actuaries could harm the financial integrity of the plans Congress intended to protect' (*Gerosa v. Savasta & Co.* 2003: 329).

Post-ERISA Legislation

Following ERISA's enactment, Congress continued to encourage employers to maintain or contribute to pension plans via three important pieces of legislation. One was the Multiemployer Pension Plan Amendments Act of 1980 (MPPAA), which declared it to be federal policy 'to alleviate certain problems which tend to discourage the maintenance and growth of multi-employer pension plans' (MPPAA 1980: §3(c)(2)). The second was the Single-Employer Pension Plan Amendments Act of 1986 (SEPPAA), which declared it to be federal policy 'to encourage the maintenance and growth of single-employer defined benefit pension plans' (SEPPAA 1986: §11002 (c)(2)). And the third was the Pension Protection Act of 2006 (PPA), which encouraged the adoption of hybrid pension plans (cash balance and pension equity plans) by, among other things, settling the long-standing dispute over whether a DB plan may express a participant's benefit on the basis of the participant's account balance and by explaining how an account-based DB plan can comply with statutory restrictions on forfeitures and age discrimination (PPA 2006).

In addition, the Tax Reform Act of 1986 overhauled the Code's coverage and nondiscrimination provisions to advance the objective of providing pension benefits to rank-and-file employees. The Senate Finance Committee report for the 1986 Act explained that, although the coverage provisions were originally intended as anti-abuse measures, the Committee's current intent was to assure that the tax incentives provided by the Code's qualified plan provisions encouraged employers to sponsor plans that covered rank-and-file employees:

For many years, the committee has supported measures that provide tax incentives designed to encourage employers to provide retirement benefits for rank-and-file employees. It has been the committee's intention that these tax incentives, which are more valuable for individuals with high levels of income because of their marginal

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tax rates, should be available to employers only if their plans provide benefits for rank-and-file employees.

Coverage tests for qualified plans originally were provided by remedial legislation in 1942 to prevent abuses. The committee is now concerned that current interpretations of the coverage tests for qualified plans, by permitting large disparities in the coverage of highly compensated employees and nonhighly compensated employees, are not sufficient to ensure broad, nondiscriminatory coverage of rank-and-file employees. The coverage rules provided by the bill are intended by the committee to deny tax benefits to plans in which the percentage of highly compensated employees who benefit under a plan is unreasonably in excess of the percentage of other employees benefiting under the plan. (S. Rep. No. 313 1985: 578)

After enacting ERISA, Congress has continued to enact legislation encouraging employers to offer employer securities as investments or investment options under ESOPs.³

Employer Migration

In the past 30 years, very few private sector employers have adopted new DB plans, and many sponsors that had previously adopted DB plans have now shut them down to one extent or another. Some employers have terminated their DB plans, while others have closed their DB plans to new entrants. Yet others have frozen accruals under their DB plans for some or all participants. Of late, some DB plans have reduced their liabilities (and their assets) by purchasing annuities (and thereby transferring a portion of their liabilities to insurance companies) or by allowing retired participants to take their benefits as lump-sum cash payments.

According to the Employee Benefits Security Administration (EBSA), the number of DB plans in the US reached its peak in the mid-1980s, when there were approximately 170,000 single-employer DB plans in the private sector. (See Tables 11.1 and 11.2.) By 2011, only 44,000 or so were left (roughly 25 percent of the corresponding mid-1980s number). In 1984, there were approximately 24 million active participants in single-employer DB plans, but in 2011, there were about 12 million (about 50 percent of the corresponding 1984 number) (EBSA 2013).⁴ While the numbers for single-employer DB plans have plummeted, the corresponding numbers for single-employer DC plans have skyrocketed, as shown by Tables 11.1 and 11.2. A DC plan with an elective deferral feature, the 401(k) plan, is now the predominant form of retirement plan. About 75 percent of all corporate retirement plans (513,496 out of a total of 680,899 in 2011) are designated as 401(k) plans, and 401(k) plans cover about 75 percent of all active retirement plan participants. (EBSA 2013).

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TABLE 11.1 Number of plans

| Type of plan | 1985 | 2001 | 2011 | Increase (Decrease) 1985–2011 |
|--------------|---------|---------|---------|----------------------------------|
| DB plan | 167,911 | 45,159 | 43,813 | (124,098) |
| DC plan | 461,158 | 685,375 | 637,086 | 175,928 |
| Total | 629,069 | 730,534 | 680,899 | 51,830 |

Source: EBSA 2013: 1.

TABLE 11.2 Number of active plan participants

| Type of plan | 1985 | 2001 | 2011 | Increase (Decrease) 1985–2011 |
|--------------|------------|------------|------------|----------------------------------|
| DB plan | 23,336,000 | 17,105,000 | 12,327,000 | (11,009,000) |
| DC plan | 32,237,000 | 50,090,000 | 70,278,000 | 38,041,000 |
| Total | 55,573,000 | 67,195,000 | 82,606,000 | 27,033,000 |

Source: EBSA 2013: 9.

Moreover, many of the remaining DB plans look quite different from the traditional ‘final average pay’ plan. Under a final average pay plan, a participant’s accrued benefit is typically expressed as an annuity commencing as of the participant’s normal retirement age, with the size of the annuity based on the participant’s years of service and final average pay. Many employers have now converted their traditional DB plans to cash balance or other hybrid forms, such as pension equity plans. Under a typical cash balance plan, for example, a participant’s benefit is expressed as an account balance, and the participant’s account is credited each year with a pay credit (a percentage of the participant’s current compensation) and an interest credit (a percentage of the participant’s account balance). According to a Towers Watson report, only seven of that year’s Fortune 100 companies offered new hires a traditional DB plan (down from 89 in 1985), and only 30 of that year’s Fortune 100 companies offered a DB plan of *any kind* to new hires (down from 90 in 1985) (McFarland 2013). See Table 11.3.

Although there is no doubt that employers have migrated away from DB plans, it is not clear why this migration has occurred. It seems unlikely that a single explanation could possibly account for the behavior of thousands of unaffiliated employers—publicly owned and closely held, for-profit and non-profit, large and small—over a thirty-year period. Indeed, there may be no single explanation that accounts for the behavior of many individual employers. Several explanations have been offered, including a desire to

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TABLE 11.3 Fortune 100 company offerings to new hires

| Type of retirement plan for new hires | 1985 | 2002 | 2013 |
|---------------------------------------|------|------|------|
| Traditional DB plan | 89 | 48 | 7 |
| Hybrid DB retirement plan | 1 | 35 | 23 |
| Total DB plans | 90 | 83 | 30 |
| DC plan only | 10 | 17 | 70 |

Source: McFarland (2013): 1.

accommodate employee preference for a benefit that is expressed as, and that can be paid as, a portable lump-sum amount and lack of employee appreciation for the value of a pension benefit that is expressed as an annuity. In addition, some explain the migration away from DB plans by pointing to employer and employee preference for a benefit that is allocated more evenly across the covered workforce than is a traditional DB plan benefit. Others point to employers' desire to shed the economic and financial accounting risks associated with DB plans, including the volatility and unpredictability of both the contribution requirements and the financial accounting expense associated with DB plans, and to employers' need to compete effectively with (1) foreign companies whose governments provide most of the pension benefits for their employees, (2) newer domestic companies that have never maintained a DB plan, and (3) other companies that have already frozen or terminated their DB plans. Other explanations that have been offered relate to employers' desire to adjust compensation expense in response to mounting health care costs and to top executives' increasing reliance on top-hat plans for retirement benefits. Others point to concerns about potential for class action litigation and to excessive regulation of DB plans (Towers Watson 2012; GAO 2009; Kennedy 2008; VanDerhei 2006; Munnell et al. 2006; *Cooper v. IBM Personal Pension Plan* 2006).

Surveys often identify the regulatory burden on DB plans as one of the reasons why employers have migrated away from DB plans. Yet published survey reports generally do not identify which specific regulatory burdens have been most onerous, nor do they identify excessive regulation as the only reason, or even as the principal reason, for employer migration. The US GAO found that employers' principal reasons for freezing DB plans were their funding volatility and the effects on employers' cash flows (GAO 2008: 6–7). Another GAO report regarding the nation's largest private DB plan sponsors found that the top three reasons for changing their DB plans for *non-bargained* employees were (1) the unpredictability or volatility of the funding requirements, (2) competitive economic pressures, and (3) trends in employee demographics (toward an older or younger workforce) (GAO

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2009). The responses for DB plans for *collectively bargained* employees were somewhat different. Here the top three reasons were (1) competitive economic pressures, (2) changes in bargaining unit demographics, and (3) increase in contributions to DC plan as a trade-off (GAO 2009).

The vast majority (74 percent) of plan sponsors that had frozen their pension plans reported that they could not conceive of any conditions that would make them consider adopting a new DB plan. Only 26 percent of plan sponsors reported that there *were* conditions under which they would consider adopting a new DB plan, the top six being (1) change in accounting treatment, (2) greater effectiveness as a retention tool, (3) reduced volatility in funding requirements, (4) DB plans becoming industry standard, (5) an increase in the tax-deductibility of contributions to DB plans (as compared to contributions to a DC plan), and (6) reduced regulatory/administrative requirements (GAO 2009).

A 2012 Towers Watson survey elicited similar responses. Plan sponsors that had closed, frozen, or terminated their DB plans reported that reducing cost and cost volatility were their two principal objectives in closing, freezing, or terminating the plan. Simplifying plan administration was near the bottom of the list of reasons given (Towers Watson 2012).

Plan regulation appears to have contributed to the migration of employers away from DB plans. Major employers initially displayed considerable interest in offering hybrid plans to their employees: the number of Fortune 100 companies offering a hybrid plan to new hires increased from one in 1985 to 35 in 2002. But this period of growth was followed by a marked decline in the popularity of hybrid plans. Between 2002 and 2013, the number of Fortune 100 companies offering a hybrid DB plan to new hires fell from 35 to 23, and during the same period, the number of Fortune 100 companies offering only a DC plan to new hires increased sharply (from 17 to 70) (McFarland 2013).

While there may be no single explanation for the peaking of interest in hybrid plans in 2002 and for the pronounced decline of interest thereafter, the views of regulators at the Treasury Department and Internal Revenue Service on hybrid plans cannot have helped. In December of 2002, the Treasury and the Service proposed highly controversial regulations regarding the age discrimination provisions of the Code. Employer-commenters asserted, among other things, that the proposed regulations would (1) impose an intricate mathematical approach that was inconsistent with the text of the statute and Congressional intent; (2) outlaw many commonplace pension plans, including plans that could not reasonably be considered age-discriminatory; (3) saddle cash balance plans with an excessively rigid 'safe harbor'; (4) subject plans and employers to the risk of years of costly litigation; (5) impose enormous economic costs on employers that sponsor DB plans; and (6) threaten the future of all DB plans (ERIC 2003).

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As a long-term financial arrangement, an employer-sponsored DB plan is subject to a variety of significant risks. A number of those risks—such as investment and interest rate risks—are potentially costly, difficult to foresee, and largely beyond the control of an individual employer and its employees. The design of a plan can affect how these risks are allocated between the sponsoring employer and participating employees. Table 11.4 identifies the principal risks that apply to pension plans and how traditional DB plans and DC plans have allocated those risks.

The impact of investment and interest rate risks was evident during the 2000–10 decade. Because of stock market and interest rate fluctuations, that decade witnessed volatile and unpredictable swings in the values of DB plan assets and liabilities. Low equity prices reduced the value of plan assets, and low interest rates increased the present value of plan liabilities. During this period, employers did not simply migrate away from DB plans; many migrated away from DB plans to DC plans, while others migrated away from traditional DB plans to hybrid plans.

Aaronson and Coronado (2005) found that, although there was a general shift away from DB plans due to factors affecting all employers and employees, certain industries experienced significantly larger increases in DC plan coverage than others. They concluded that some employers and employees preferred more flexible, short-term employment arrangements, and therefore favored pension plans that, unlike traditional DB plans, provided for even rates of benefit accrual and did not penalize job change. Employers preferring more flexible employment relationships included companies finding that, due to the pace of technological change, their future success did not depend on long-term employment relationships. Employees preferring more flexible, short-term relationships included mobile employees who moved from employer to employer in search of better opportunities, members of two-earner couples whose employment decisions were affected by the other member's employment opportunities, and parents who had young children and who moved in and out of the workforce depending on the needs of their children.

Plan Design Options

Although DC plans have some advantages over DB plans, and particularly over traditional DB plans, some employees may not be prepared to handle the risks that DC plans impose on plan participants. Several design options are among those available to employers concerned with employees' ability to bear the risks that DC plans impose on plan participants. These design options include the following:

TABLE 11.4 Allocation of risks under DB and DC plans

| Risk | Traditional DB plan | DC plan |
|---|---|---|
| Investment risk: the risk that the plan's investments will not perform as well as expected. | The employer bears all of the investment risk. | Plan participants bear all of the investment risk. |
| Interest rate risk: the risk that a change in interest rates will cause the present value of retirement plan liabilities to change. | The employer bears all of the interest rate risk. For example, all other things being equal, a decline in interest rates tends to increase the present value of the plan's liabilities (and to increase the employer's funding obligations and financial accounting expense). To some extent the effect on the present value of liabilities may be offset by the effect of the change in interest rates on the value of the plan's assets. | Because the value of the plan's liabilities equals the value of the plan's assets, there generally is no interest rate risk independent of investment risk (the risk that interest rate changes will affect the value of the plan's assets). (An exception: a money purchase pension plan with a funding waiver.) |
| Inflation risk: the risk that inflation will erode the value of the benefits provided by the plan. | Unless the plan provides for an automatic COLA, participants bear the risk of inflation. If benefits are based on the participant's final pay, and the participant receives pay increases that keep up with (or surpass) inflation, the plan can help the participant to keep up with <i>pre-retirement</i> inflation. The employer bears the cost of any increases in benefits that are attributable to a COLA or to increases in employees' pay levels. | Participants bear the risk of inflation. To the extent that appreciation in the value of the plan's investments keeps up with (or surpasses) inflation, the plan can help a participant to cope with inflation. |
| Accrual/contribution rate risk: the risk that the rate at which benefits are earned will decline. | Participants bear this risk, but the employer typically determines whether the accrual rate declines. If the plan accepts participant contributions, participants also determine whether the contribution/accrual rate declines. | Participants bear this risk, but the employer typically determines whether the contribution rate declines. If the plan accepts participant contributions, participants also determine whether the contribution rate declines. |

(continued)

TABLE 11.4 Continued

| Risk | Traditional DB plan | DC plan |
|--|--|---|
| <p>Annuity purchase rate risk: the risk that the rate at which annuities may be purchased will change.</p> | <p>An annuity is typically provided by the DB plan itself rather than by an insurer. If, however, the plan provides annuity benefits by purchasing annuity contracts from insurers, the plan and the employer bear the annuity purchase rate risk. Annuity purchase rates are affected by interest rates and other factors, such as supply and demand conditions. Annuity purchase rate risk can be borne by participants who intend to receive benefits from the plan in a lump sum and to use the proceeds to purchase an annuity from an insurer.</p> | <p>Participants typically bear this risk. The annuity purchase rate risk typically applies under a DC plan that offers an annuity as an optional payment method.</p> |
| <p>Employment termination risk: the risk that a participant will terminate employment before (or after) reaching the point at which the participant is eligible for the benefit with the highest value under the plan.</p> | <p>The employer and plan participants bear this risk. Traditional DB plans provide meaningful retirement benefits only to long-service employees. For example, under a traditional DB plan with an early retirement subsidy, the value of the employee's retirement benefit can increase substantially once the employee attains early retirement age. An employee who would otherwise be eligible for early retirement can suffer a significant loss in value if the employee terminates employment before (or after) early retirement age.</p> | <p>Under a DC plan, all other things (such as compensation) being equal, benefits accrue evenly over a participant's career, so that there is less risk to an employee's retirement savings if a participant switches jobs in mid-career. Some employers provide a matching or other contribution only to plan participants who are employed on the last day of the year (Yang 2014).</p> |
| <p>Plan termination risk: the risk that the plan will terminate without sufficient funds to meet its benefit obligations.</p> | <p>If the plan is covered by the termination insurance program in Title IV of ERISA, both the employer and plan participants share this risk. Depending on the employer's financial condition, the employer may bear some of the risk, and plan participants may bear the risk for benefits in excess those covered by PBGC insurance.</p> | <p>There is a risk that the plan will terminate before the employer makes all of the contributions that are then due under the plan (for example, the contributions for the then-current year). Depending on the employer's financial condition, the employer and/or the plan participant may bear the risk.</p> |
| <p>Longevity risk: the risk that the participant (and any</p> | <p>The presumptive form of distribution is required to be an annuity under a DB plan. If a participant in a DB plan</p> | |

survivor) will live longer than anticipated and exhaust the participant's retirement savings.

receives his or her benefits from the plan as an annuity, the plan, rather than the participant, bears the longevity risk.

DB plans are permitted, however, to allow a participant to elect (with spousal consent) to receive the actuarial equivalent of the participant's accrued benefit in a lump sum. If a plan distributes benefits in the form of a lump sum, the participant bears the longevity risk—and runs the risk that the participant will spend the entire lump sum before the participant dies—unless the participant transfers the longevity risk to an insurer by using the lump sum to purchase an annuity contract.

The risk falls on the participant unless the participant transfers the risk to an insurer by using the lump sum to purchase an annuity contract. Typically, it is more expensive to purchase an annuity from an insurer than it is to obtain an annuity directly from a DB plan.

Source: Author's analysis.

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- DC Plan Equity Fund with a Rate-of-Return Guarantee. Concerns about the incidence of investment risk under a DC plan might be addressed by offering investment options that provide participants with more downside protection, such as an investment-linked variable annuity with an investment guaranty offered by an insurance company. However, such offerings come at a price, typically in the form of higher fees, lower investment returns, or both.
- A DB/DC Floor-Offset Arrangement. Depending on the DC plan's contribution formula, the DB plan's benefit formula, and the plans' investment policies, a floor-offset arrangement might offer participants both the upside potential of a DC plan and the downside protection of a DB plan. Nevertheless, the funded status of the DB component of a floor-offset plan can be even more volatile than the funded status of a stand-alone DB plan.
- A Cash Balance Plan Offering an Investment Return. An employer might adopt a cash balance retirement plan under which much of the investment risk is allocated away from the employer and to plan participants, subject to the zero cumulative floor mandated by the Pension Protection Act of 2006, in accordance with the current proposed and final Treasury cash balance plan regulations. In this case, the plan's assets can be invested in a fashion that mirrors the investments used to determine the investment performance of the plan's account balances. This approach addresses employers' concerns regarding the volatility and unpredictability of employer contributions and expenses under a DB plan, but it does not offer an employee much more than what is already available under a DC plan (except that the relevant deduction and benefit limits would be the limits for DB plans).
- A Cash Balance Plan Offering an Investment Return with a Floor Exceeding the Zero Cumulative Floor Mandated by the PPA. Under current proposed and final Treasury regulations, cash balance plans are required to operate like DC plans and to shift *all* of the investment risk to plan participants (subject to the zero cumulative floor mandated by the PPA). If anticipated forthcoming Treasury Department regulations so permit, an employer might adopt a cash balance retirement plan under which investment risk is shared by the employer and plan participants. It remains to be seen whether the Treasury responds affirmatively to the objection made in the comments to the proposed regulations. By combining the best features of DB and DC plans, cash balance plans could offer participants an account-based benefit that includes a market-based rate of return with lower investment risk than a traditional DC plan. For example, a DB plan can provide annuities at lower cost, subsidized disability and death benefits, and subsidized early

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- retirement (or early retirement window) benefits. Moreover, plan fiduciaries could find it easier to reduce funding volatility by matching plan investments with their plans' future benefit obligations (Shea et al. 2011).
- **Investment education.** It is difficult to quarrel with the desirability of providing investment education to participants in DC plans that allow them to determine how the funds in their accounts will be invested. The US Department of Labor's interpretive bulletin on investment education explains how an employer can provide investment education without providing investment advice. By contrast, the provision of investment advice to plan participants might qualify as fiduciary conduct and might therefore subject the employer and others to potential liability as fiduciaries under ERISA (I.B. 1996).
 - **Investment advice.** The US Department of Labor has also published a regulation that allows fiduciaries to provide investment advice to participants in participant-directed individual account plans without violating the conflict-of-interest rules in the Code and ERISA. Designating an investment advisor in accordance with the regulation is a fiduciary act, however, and compliance with the regulation does not relieve the party making the designation of the obligation to make the designation in accordance with ERISA's fiduciary standards (Investment Advice Regulation 2011).
 - **Payout education.** If a plan offers a lump-sum option, employees strongly favor taking their benefits in the form of a lump-sum payment when they leave the firm, regardless of whether the plan is a DB or a DC plan. Employees who take their benefits in the form of a lump-sum payment, however, incur the risk that they will exhaust their retirement savings before they die. A growing body of research indicates that employees would be well-advised to address the risk that they will outlive their retirement savings by including annuities in their investment portfolios. Many employees do not understand annuities, however, and are concerned that they don't know enough about them to make informed decisions. Employers are in a position to educate their employees about annuities, but some employers remain concerned that any assistance that they provide will expose them to fiduciary liability under ERISA (Purcell 2009).

Conclusion

The basic policy decision that the US Congress made in the Code and ERISA was that the employer, not the government, should decide whether the employer will offer benefit plans to its employees and, if so, that the

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employer, not the government, should select the benefit plans and the benefits that will be offered. Moreover, the plan cultivation provisions in ERISA and the Code apply to both DB and DC plans and are designed to encourage employers to maintain the benefit plans that they prefer, not to require employers to maintain a particular type of plan. If the plan cultivation provisions were fundamentally flawed, one would expect to observe migration away from *both* DB and DC plans. Nevertheless, during the period from 1985 to 2011, the number of active participants in single-employer DC plans has more than doubled. During the same period, the percentage of *Fortune* 100 companies offering new hires some form of retirement plan has remained constant at 100 percent.

The differences between DB and DC plans, and between traditional pension plans and hybrid plans, suggest that the migration away from traditional DB plans was attributable primarily to employers' desire to avoid volatile and unpredictable swings in contribution requirements and financial accounting expenses, paired with employers' and employees' preference for plans that allocate benefits more evenly than do traditional DB plans. Although concerns about the burdens imposed by the regulatory provisions of the Code and ERISA appear to have influenced employers' decision-making, particularly with respect to the movement away from DB plans during the past decade, such concerns do not appear to have been the primary cause of the migration away from traditional DB plans in general.

Appendix

APPENDIX TABLE 11.A1 ERISA committee reports

| Committee | Report Text |
|--|---|
| Senate Committee on Labor & Public Welfare S. Rep. No. 127 1973: 8, 13, 18–19 | 'Although the need for legislative reform has been and continues to be widely acknowledged among all persons and sectors affected, governmental supervision of mandated and essential improvements has been resisted due to the belief that such legislation might impede plan growth. However, as the Committee has progressed in its inquiries and made public disclosures of its analysis and findings, it has been discerned that some resistance has been dissipated and various opponents have now acknowledged that such reforms will not deter the establishment or the improvement of pension plans.' 'The enactment of progressive and effective pension legislation . . . should serve to encourage rather than diminish efforts by management and industry to expand pension plan coverage and to improve benefits for workers.' |

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‘The Committee also concluded that an exemption for plans of small size was necessary in order to prevent discouraging small employers from establishing pension plans While reasonable men may differ in their judgment as to whether a small plan exemption would encourage greater expansion of private pension plans among small businessmen, it is the Committee’s judgment that subjecting all plans, regardless of size, to the standards of this Act could have an inhibiting effect on future private pension expansion.’

Senate Committee on
Finance
S. Rep. 383 1973: 1, 10–11,
18–19

‘The [bill] as reported by the committee is designed to make pension, profit-sharing, and stock bonus plans more effective in providing retirement income for employees who have spent their careers in useful and socially productive work. It encourages provision for the retirement needs of many millions of individuals. At the same time, the committee recognizes that private retirement plans are voluntary on the part of the employer, and, therefore, it has carefully weighed the additional costs to the employer and has minimized them to the extent consistent with the minimum standards for retirement benefits.’

‘A fundamental aspect of present law, which the committee bill continues, is reliance on voluntary action by employers (and employees under contributory plans) for the establishment of qualified retirement plans. The committee bill also continues the approach in present law of encouraging the establishment of retirement plans which contain socially desirable provisions through the granting of tax inducements. In other words, under the new legislation as under present law, no one is compelled to establish a retirement plan. However, if a retirement plan is to qualify for the favorable tax treatment, it will be required to comply with specified new requirements which are designed to improve the retirement system. Since the favorable tax treatment is quite substantial, presently involving a revenue loss of over \$4 billion a year, it is anticipated that plans will have a strong inducement to comply with the new qualification rules and thereby become more effective in fulfilling their objective of providing retirement income.’

‘[T]he committee is aware that under our voluntary pension system, the cost of financing pension plans is an important factor in determining whether any particular retirement plan will be adopted and in determining the benefit levels if a plan is adopted, and that unusually large increases in costs could impede the growth and improvement of the private retirement system. For this reason, in the case of those requirements which add to the cost of financing retirement plans, the committee has

(continued)

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APPENDIX TABLE 11.A1 Continued

| Committee | Report Text |
|--|--|
| House Committee on Education & Labor H.R. Rep. No. 533 1973: 1–2 | <p>sought to adopt provisions which strike a balance between providing meaningful reform and keeping costs within reasonable limits.’</p> <p>‘If employers respond to more comprehensive coverage, vesting and funding rules by decreasing benefits under existing plans or slowing the rate of formation of new plans, little if anything would be gained from the standpoint of securing broader use of employee pensions and related plans.’</p> <p>‘The primary purpose of the bill is the protection of individual pension rights, but the committee has been constrained to recognize the voluntary nature of private retirement plans. The relative improvements required by this Act have been weighed against the additional burdens to be placed on the system. While modest cost increases are to be anticipated when the Act becomes effective, the adverse impact of these increases have been minimized. Additionally, all of the provisions in the Act have been analyzed on the basis of their projected costs in relation to the anticipated benefit to the employee participant. In broad outline, the bill is designed to: (1) establish equitable standards of plan administration; (2) mandate minimum standards of plan design with respect to the vesting of plan benefits; (3) require minimum standards of fiscal responsibility by requiring the amortization of unfunded liabilities; (4) insure the vested portion of unfunded liabilities against the risk of premature plan termination; and (5) promote a renewed expansion of private retirement plans and increase the number of participants receiving private retirement benefits.’</p> |
| House Committee on Ways & Means H.R. Rep. No. 807 1974: 2 | <p>‘The bill encourages provisions for the retirement needs of many millions of individuals. At the same time, the committee recognizes that private retirement plans are voluntary on the part of employers, and, therefore, it has weighed carefully the additional costs to employers and minimized those costs to the extent consistent with minimum standards for retirement benefits. . . .</p> <p>The bill continues to rely primarily on the tax laws to secure needed improvements in pensions and related plans. In general, it retains the tax incentives granted under present law for the purpose of encouraging the establishment of plans which contain socially desirable provisions. However, it also improves the effectiveness of these tax incentives by extending or increasing them in certain cases where this is warranted and by pruning them where they have given rise to problems.’</p> |

Sources: As indicated in this table.

Acknowledgements

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Endnotes

1. See *Pegram v. Herdrich* (2000: 225): ‘Professor Scott’s treatise admonishes that the trustee “is not permitted to place himself in a position where it would be for his own benefit to violate his duty to the beneficiaries.” Under ERISA, however, a fiduciary may have financial interests adverse to beneficiaries’. Langbein (2007: 1327): ‘This concession to employer interests, which departs notably from the trust tradition, was motivated by the concern that without it employers would be less likely to sponsor benefit plans. Because pension and welfare benefit plans entail major expenditures, the sponsor community prefers to have its own managers administering and monitoring plan operations for cost containment, a traditional management function’ (footnotes omitted).
2. ‘To preserve and encourage ESOPs, Congress exempted fiduciaries of ESOPs from the duty to diversify and limited the duty of prudence so as not to require diversification for such plans.’
3. See, for example, *Fifth Third Bancorp v. Dudenhoeffer* (2014: 21): ‘Congress, in seeking to permit and promote ESOPs, was pursuing purposes other than the financial security of plan participants’; *In re Citigroup ERISA Litig.* (2011: 137): ‘Due to the risk inherent in employees’ placing their retirement assets in a single, undiversified stock fund, Congress has expressed concern that its goal of encouraging employee ownership of the company’s stock could “be made unattainable by regulations and rulings which treat employee stock ownership plans as conventional retirement plans”’; (*Steinman v. Hicks* 2003: 1103): ‘Congress, believing employees’ ownership of their employer’s stock is a worthy goal, has encouraged the creation of ESOPs both by giving tax breaks and by waiving the duty ordinarily imposed on trustees by modern trust law (including ERISA) to diversify the assets of a pension plan’ (citations omitted); *Moench v. Robertson* (1995: 568): ‘Under their original rationale, ESOPs were described as... devices for expanding the national capital base among employees—an effective merger of the roles of capitalist and worker. Thus, the concept of employee ownership constituted a goal in and of itself. To accomplish this end, Congress... enacted a number of laws designed to encourage employers to set up such plans’ (internal quotation marks and citations omitted).
4. For years preceding 2005, EBSA used data that excluded (1) individuals who were eligible to participate in a §401(k) plan but who did not elect to have contributions made on their behalf and (2) non-vested former employees who had not yet completed the plan’s break-in-service period. For 2005 and subsequent years,

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EBSA has relied on data that treat these individuals as ‘active participants.’ EBSA has stated, however, that because these individuals are not contributing to the plan and are not entitled to receive benefits under the plan, EBSA has adjusted the reported active participant counts to provide more meaningful statistics. ‘In a purely economic sense, and for research purposes, individuals in these groups should not be included in the count of active participants’ (EBSA 2013: 40–1).

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