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## Rethinking the Risk of Defined Contribution Plans

Regina T. Jefferson

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## Rethinking the Risk of Defined Contribution Plans

Regina T. Jefferson\*

I.	INTRODUCTION .....	609
A.	<i>Plan Classification</i> .....	610
B.	<i>The Shift From Defined Benefit Plans to Defined Contribution Plans</i> .....	614
C.	<i>Shortfalls in Defined Contribution Plans</i> .....	616
II.	THE PRIVATE PENSION PROGRAM AND THE FIDUCIARY LAW .....	620
A.	<i>Fiduciary Standards</i> .....	620
B.	<i>Fiduciary Breach Under ERISA</i> .....	623
C.	<i>The Fiduciary Rules and Participant Directed Plans</i> .....	627
1.	<i>Investment Practices and Participant Directed Plans</i> .....	628
2.	<i>The Education and Notification Requirement in Participant Directed Plans</i> .....	630
3.	<i>Section 404(c) Plans</i> .....	632
D.	<i>Pension Policy and Participant Directed Plans</i> .....	634
E.	<i>Residual Liability and a Notification and Education Requirement</i> .....	636
F.	<i>Enforcement of a Notification and Education Requirement</i> .....	639
III.	INSURANCE PROTECTION AGAINST MARKET FLUCTUATIONS .....	640
A.	<i>The Gap in Insurance Protection</i> .....	640
B.	<i>Reasons for Shortfalls</i> .....	641
C.	<i>Insurance Protection Outside of ERISA</i> .....	645
1.	<i>Guaranteed Investment Contracts</i> .....	645

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	2.	<i>Banking Investment Contracts</i> . . . . .	647
	3.	<i>Retirement Certificates of Deposit (Cds)</i> . . . . .	648
D.		<i>Defined Contribution Plan Insurance</i> . . . . .	649
E.		<i>The Hypothetical Account Proposal—An Insurance Model</i> . . . . .	651
	1.	<i>Calculation of the Guaranteed Benefit</i> . . . . .	654
	2.	<i>The Hypothetical Account Proposal and Insurance Premiums</i> . . . . .	660
	3.	<i>Noncompliant Investment Allocations</i> . . . . .	661
	4.	<i>Private Insurers</i> . . . . .	662
F.		<i>Regulating Defined Contribution Plan Insurance</i> . . . . .	663
	1.	<i>The Moral Hazard Problem</i> . . . . .	663
	2.	<i>The Impact of Defined Contribution Plan Insurance on the PBGC</i> . . . . .	665
	3.	<i>The Problem of Bailouts</i> . . . . .	667
G.		<i>The Floor-Offset Pension Plan Comparison</i> . . . . .	669
IV.		<b>FUNDING SHORTAGES IN DEFINED CONTRIBUTION PLANS</b> . . .	671
A.		<i>Funding Under ERISA</i> . . . . .	671
B.		<i>Minimum Funding Standards and Past Service Credits</i> . . . . .	674
C.		<i>Past Service Liabilities in Defined Contribution Plans</i> . . . . .	676
D.		<i>The Funding Rules and Defined Contribution Plans</i> . . . . .	680
V.		<b>CONCLUSION</b> . . . . .	681

## I. INTRODUCTION

In response to pension funding failures and concern that abuses in the private pension system were denying benefits to many workers, Congress passed the Employee Retirement Income Security Act of 1974 (ERISA).<sup>1</sup> ERISA has several specific objectives: to ensure that workers receive pension benefits after they satisfy certain minimum requirements, to ensure that sufficient funds are set aside to pay promised pension benefits, to ensure that workers receive adequate information about their employee benefit plans, and to set higher standards of conduct for those managing employee benefits and pension funds.<sup>2</sup> ERISA has been successful in accomplishing many of its goals.<sup>3</sup> Today employees vest earlier, more plans are adequately funded, and plan participants are more knowledgeable about their retirement benefits.<sup>4</sup> Moreover, since the passage of ERISA, increased participation and contribution rates in private pension plans have caused the average income of retired individuals to be comparable to that of the rest of the population.<sup>5</sup>

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1. The Employee Retirement Income Security Act, better known as ERISA, is a massive piece of legislation. ERISA, Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified as amended in scattered sections of Titles 26 and 29 U.S.C.). It originated as early as 1962 when President John F. Kennedy commissioned a special cabinet-level task force to evaluate the impact of private retirement programs on the nation's economy and public policy, as well as the investment policies of these programs and whether they were sufficient to provide promised benefits to the participants. See 120 Cong. Rec. S15,743 (1974) (statement of Sen. Javits). More than a decade later, on September 2, 1974, President Ford signed ERISA into law. ERISA completely revised the legal framework of the qualified pension plan. Enforcement of significant innovations of ERISA were divided among the Internal Revenue Service, Department of Labor, and the Pension Benefit Guaranty Corporation.

2. It is hereby declared to be the policy of this Act [ERISA] to protect . . . the interests of participants in employee benefit plans and their beneficiaries, by requiring the disclosure and reporting to participants and beneficiaries of financial and other information with respect thereto, by establishing standards of conduct, responsibility and obligation for fiduciaries of employee benefit plans, . . . by requiring them to vest the accrued benefits of employees with significant periods of service, to meet minimum standards of funding, and by requiring plan termination insurance.

ERISA § 2(b), 29 U.S.C. § 1001(b)-(c) (1999).

3. The growth of the pension system has resulted in an enormous accumulation of pension assets. Private and public pension funds currently hold more than \$4.5 trillion in assets. This staggering sum reveals that a very large percentage of personal savings and of aggregate capital formation in the United States occurs through the medium of pension plans. Paul Yakoboski et al., PBGC Solvency: Balancing Social and Casualty Insurance Perspectives, Employee Benefit Research Institute Issue Brief No. 126, 5-6 (May 1992) [hereinafter PBGC Solvency].

4. See generally John R. Keville, Note, *Retire at Your Own Risk: ERISA's Return on Investment?*, 68 St. John's L. Rev. 527, 528 (1994).

5. Although much attention has been devoted to the widely known decrease in participation rates and pension sponsorship in the 1980s, relatively little attention has been

### A. Plan Classification

Retirement plans are divided into two distinct categories: defined benefit plans and defined contribution plans.<sup>6</sup> Both types of plans can have similar income replacement objectives and can be used equally effectively for retirement saving purposes.<sup>7</sup> Structurally, however, the two types of plans are very different; the distinguishing feature is risk allocation.<sup>8</sup> A defined benefit plan pools the plan's assets in an aggregate trust fund and promises a fixed amount to plan participants at retirement regardless of investment performance.<sup>9</sup> In a

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focused on the reversal of these trends during the last several years. See Paul Yakoboski & Celia Silverman, *Baby Boomers in Retirement: What are Their Prospects?* Employee Benefit Research Institute Issue Brief No. 151, 14-15 (July 1994); see also William F. May, *Future Policies for Employer-Based Pension Plans, in Search for a National Retirement Income Policy* 101, 103 (Jack L. VanDerhei ed., 1987). The bulk of retirement income increasingly comes from employer sponsored pension plans. *Id.* at 14-15. As of 1983, one thousand of the largest nonfederal pension plans held assets of approximately \$806 billion. *Id.* at 102-04. A nation wide survey in May 1983 by the Employee Benefit Research Institute and the U.S. Department of Health and Human Services indicated that approximately 56% of the 88 million nonfarm workers in America were covered by a private pension plan. See John H. Langbein & Bruce A. Wolk, *Pension and Employee Benefit Law* 25 (2d ed. 1995) (citation omitted). In 1993, participation increased so that private and public pension plans held more than \$4.6 trillion in assets. See *id.* at 20, 736 (citation omitted). This figure represents more than a 300% increase from 1983. See *id.*

6. See ERISA § 3(34), 29 U.S.C. § 1002(34) (1999) (defining "defined contribution plan" as a "pension plan which provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant's account, and any income . . . which may be allocated to such participant's account"); *id.*, ERISA § 3(35), 29 U.S.C. § 1002(35) (1999) (defining "defined benefit plan" as a "pension plan . . . which is not an individual account plan and which provides a benefit derived from employer contributions which is based partly on the balance of the separate account of a participant"); see also Keville, *supra* note 4, at 528; Mary E. O'Connell, *On the Fringe: Rethinking the Link Between Wages and Benefits*, 67 *Tul. L. Rev.* 1421, 1489 (1993).

7. In a defined contribution plan the expected benefit may not be received because of inadequate investment performance, or because plan participants may decline to make elective contributions. Daniel I. Halperin, *Retirement Security and Tax Equity: An Evaluation of ERISA*, 17 *B.C. Ind. & Com. L. Rev.* 739, 775-76 (1976) (stating "it is necessary to decide whether defined contribution plans in fact do not promise a specific benefit. Money purchase plans have a fixed contribution which under ERISA must be made annually. While profit-sharing plans do not have a definite contribution, in many circumstances the employer fully intends to contribute the maximum permissible amount.").

8. Daniel I. Halperin, *Tax Policy and Retirement Income: A Rational Model for the 21st Century*, in *Search for a National Retirement Income Policy* 159, 184 (Jack L. VanDerhei ed., 1987).

9. See Jon Fitzpatrick, *Determining if a Small Company Needs a Retirement Plan, and Choosing the Best Plan*, 14 *Tax'n for Law.* 76, 78 (1985) (discussing the two types of plans).

defined benefit plan the sponsoring employer is liable for the payment of plan benefits and therefore bears the risk of accumulating insufficient assets.

To protect defined benefit plan participants in the event that an employer becomes insolvent, the Pension Benefit Guaranty Corporation (PBGC) insures a limited accrued benefit, which is phased in over a five-year period.<sup>10</sup> The maximum insurable benefit is approximately \$35,000 per year for an individual who retires at age 65.<sup>11</sup> To the extent that a participant's vested retirement benefit exceeds the maximum insurable limit, the participant bears the risk of insolvency. Relatively few plan participants, however, have vested accrued benefits in excess of the insurable limit.<sup>12</sup>

In contrast to the defined benefit plan's aggregate trust, a defined contribution plan assigns each participant an individual account.<sup>13</sup> At retirement the participant receives the entire account balance. The relative success or failure

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10. ERISA, 29 U.S.C. §§ 1301-1311 (1999). Section 1302(a) details why Congress created the PBGC. One of the purposes behind the creation of the PBGC was "to provide for the timely and uninterrupted payment of pension benefits to participants and beneficiaries under plans to which this subchapter applies." *Id.* § 1302(a)(2).

11. When a plan terminates with insufficient assets, the PBGC is required to pay accrued, vested benefits to plan participants up to a guaranteed amount. ERISA limits the "basic guaranteed benefit" payable by the PBGC to the lesser of the average monthly gross income, based on the highest compensation in any consecutive five-year period, or \$750 per month, adjusted by the cost of living. See 29 C.F.R. § 4022.22 (1999). Basic benefits "include all retirement, death, and disability benefits of current retirees and, for vested current participants, the regular retirement benefit payable under the normal annuity form." Alicia H. Munnell, *ERISA—The First Decade: Was the Legislation Consistent With Other National Goals?*, 19 U. Mich. J.L. Ref. 51, 54 (1985). "Basic benefits do not include lump-sum and special supplementary benefits payable under some plans to encourage early retirement." *Id.* ERISA also imposes a limit on the insured amounts. For example, in 1998, the PBGC insured up to a maximum monthly benefit of \$2,880.68, \$34,568.16 per year, payable in the form of a life annuity commencing at age 65 to a participant in a plan that terminated in 1998. See Pension Guarantees, <<http://www.pb.gc.gov/ygptabl.htm>>, Mar. 1999; 29 C.F.R. § 4022.22(b) (1999). ERISA initially provided that upon plan termination, employers were liable to the PBGC for any plan asset insufficiencies up to a maximum of 30% of the employer's net worth, and the PBGC absorbed the excess liability. The 30% cap gave employers an incentive to terminate their plans when their unfunded insured liability exceeded 30% of the employer's net worth. ERISA was amended in 1986 to avoid this result. The Single Employer Pension Plan Amendments Act of 1986 (SEPPAA) limited the employer's ability to terminate plans with unfunded vested accrued benefits. Single Employer Pension Plan Amendments Act of 1986, Pub. L. No. 99-272, 100 Stat. 237 (codified as amended in scattered sections of 29 U.S.C.).

12. Langbein & Wolk, *supra* note 5, at 831. Thus, the guaranteed benefit can differ drastically from the benefit promised by the plan.

13. Defined contribution plans provide individual accounts for each participant. Benefits are based solely upon the amount contributed to the participant's account, with adjustments for any income, expenses, gains, and losses. Account balances also may be adjusted for forfeitures of the accounts of other participants. See 29 U.S.C. § 1002(34) (1999).

of the plan depends on how well the assets have been invested.<sup>14</sup> There is no PBGC protection because the retirement benefit is determined by the account balance, and not by a specific benefit.<sup>15</sup> Thus, in a defined contribution plan, the participant, rather than the employer and the PBGC, bears the risk of accumulating insufficient assets for retirement.<sup>16</sup>

The most important objective of a retirement program is to provide a level of replacement income during retirement sufficient to provide a life style commensurate with that of an individual during her working life.<sup>17</sup> In both defined benefit and defined contribution plans, the income replacement goal can be seriously threatened by fiduciary breach, poor investment, or inadequate funding.<sup>18</sup> When one or all of these events occur, however, it is more likely that defined contribution plans ultimately will provide retirement benefits that fall short of their goals because such plans are neither PBGC insured nor adequately protected by the fiduciary and funding rules.

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14. Douglas A. Love, *ERISA: The Law Versus Economics*, 25 Ga. L. Rev. 135, 136 (1990).

15. The PBGC is to provide broad insurance coverage for pension plans, but with limits: "Except as provided in subsection (b) of this section, this subchapter applies to any plan . . ." 29 U.S.C. § 1321(a) (1999). The most important exception for defined contribution plans: "This section does not apply to any plan—(1) which is an individual account plan [a defined contribution plan] . . ." *Id.* § 1321(b). Thus, defined contribution plans are not insured by the PBGC. With no particular, identifiable benefit, there is no appropriate amount to insure. See S. Conf. Rep. No. 93-383 (1974), reprinted in 1974 U.S.C.C.A.N. 4890, 4911. The PBGC requires minimum funding standards to be met as a condition of protection, but the funding standards set out by the IRC and ERISA generally do not apply to defined contribution plans since by their nature the amount of funding is merely the individual account balance. See Jay Conison, *Employee Benefit Plans in a Nutshell* 413 (1993).

16. See Deborah S. Prutzman & Edwin C. Laurenson, *Impact of ERISA on Choice of Mutual or Collective Investment Funds as Funding Vehicles*, 651 PLI/Comm 789, 805 (Feb.-Mar. 1993); Yakoboski et al., *PBGC Solvency*, *supra* note 3, at 4; see also *infra* Part II.C.1.

17. A large gap exists between what most people expect to receive during their retirement and what they actually will receive. "[A] secure retirement will depend on having a three-legged stool of income from Social Security, an employer-sponsored pension, and personal savings." Susan Mitchell, *How Boomers Save*, *Am. Demog.*, Sept. 1994, at 22. Most have not saved enough to meet their demands. See Steven Brostoff, *Workers Save More for Retirement; Still Fall Short*, *Nat'l Underwriter Life & Health Fin. Svcs.* Ed. Dec. 23, 1996, at 6. The annual Workplace Pulse survey for 1996, sponsored by Colonial Life and Accident and ECFC, stated that the average 30-year-old worker would have to save \$662 more each year "to achieve an annual retirement income of \$26,256 in 1996 dollars." *Id.* The survey also stated that "[a] 60-year-old worker with \$140,000 already saved for retirement would need to save an additional \$2,325 a month to achieve an annual retirement income of \$26,256." *Id.* "Married-couple households headed by 35-to-44-year-olds with a total income of \$40,000 to \$60,000 a year need to save \$200,000 by age 65 to maintain a similar standard of living after retirement, if they have a pension. Those without a pension need to save \$270,000." Mitchell, *infra*, at 25.

18. See discussions *infra* Part II.B; Part II.C; and Part IV.A.

When ERISA was enacted, defined benefit was the predominant plan type.<sup>19</sup> Defined contribution plans typically were used as supplemental plans. Since the passage of ERISA, the composition of the private pension system has changed dramatically.<sup>20</sup> In recent years, there has been a discernable movement toward using defined contribution plans as primary retirement saving vehicles.<sup>21</sup> This trend has serious implications for the private pension system because it shifts the risk of accumulating insufficient retirement assets from the sponsoring

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19. Between 1975, the year ERISA became effective, and 1990, the total number of private defined benefit plans increased from 103,000 in 1975 to 175,000 in 1983, then fell to 113,000 in 1990. Celia Silverman et al., *Employee Benefit Research Institute, EBRI Databook on Employee Benefits 139* (3rd ed. 1995) [hereinafter *EBRI Databook*]. Meanwhile, the total number of private defined contribution plans increased from 208,000 in 1975 to 599,000 in 1990. *Id.*

20. The composition of the workforce has changed as well. See *EBRI Databook*, *supra* note 19, at 7-10. The number of workers between the ages of 55 and 64 will increase from 11.3 million in 1970 to 17.4 million in 2005. See Gerald Cole & Marjorie N. Taylor, *Caught Between Demographics and the Deficit: How Can Retirement Plans Meet the Challenges Ahead?*, *Comp. & Ben. Review* 32, 32 (Jan.-Feb. 1996). This increase in the number of older workers is predicted to result in a skills gap between generations. More jobs are predicted to be open, however they will be entry level positions. The older generation will create what is termed the "graybeard ceiling" by staying in upper level positions, preventing advancement and training for the next generation. When the baby boomers finally retire, the next generation will be too under-skilled to move into their positions. See Ron Stodghill, II, *The Coming Job Bottleneck*, *Bus. Wk.*, Mar. 24, 1997, at 184. Not only is the workforce aging rapidly, but it is becoming increasingly transient. "American workers born after World War II will have at least 10 jobs over the course of their working lives. Workers who do not remain at a single job for a long period are better served by defined contribution plans" because they vest immediately and are easily rolled into a new employer's plan or individual retirement account. Keville, *supra* note 4, at 542 (footnotes omitted). But see Yakoboski & Silverman, *supra* note 5, at 21-27. Yakoboski and Silverman argue that boomers are, in fact, expected to have longer tenure figures (as of retirement) than previous generations, so they could not be more mobile. See *id.* at 23-24. Boomers already had higher tenure levels than their predecessors when they hit age groups 25-34 and 35-44 in 1991, and tenure levels were higher in the 1980s and 90s for both men and women than in the 1950s, 60s, or 70s. See *id.* Yakoboski and Silverman also posit that the increase in the number of defined contribution plan participants is due mostly to small firms adding the plans, especially 401(k) plans, where they previously had none. See *id.* at 21-23.

21. As a percentage of the total number of private pension plans, the number of defined benefit plans fell from 33% in 1975 to 16% in 1990. See Yakoboski & Silverman, *supra* note 5, at 21 (Table 14). Defined contribution plans have increased as a percentage of aggregate private pensions from 67% in 1975 to 84% in 1990. See *id.* As of the end of 1992, private defined benefit plans held \$1.57 trillion in assets and private defined contribution plans held \$911 billion. Similar changes took place with regard to the number of participants in defined contribution and defined benefit plans between 1975 and 1990; however, the number of participants in defined benefit plans continues to exceed the number of participants in defined contribution plans. *Id.*; see also Keville, *supra* note 4, at 529. However, recent trends show an increase in the establishment of defined contribution plans so that in a few years defined contribution plans are likely to be the prevalent plan type, assuming no major changes in pension law.



employer to the employee. The use of defined contribution plans as primary savings vehicles also eliminates the significance of many of the protective measures introduced by ERISA.<sup>22</sup> Consequently, unless Congress amends the pension law as it applies to defined contribution plans, many future retirees may not receive the retirement benefits that they expect, or the level of protection envisioned by the drafters of ERISA. The prospect of benefit shortfalls in defined contribution plans will become an increasingly serious societal problem as more and more participants depend on them for their retirement security.

### B. *The Shift From Defined Benefit Plans to Defined Contribution Plans*

Defined contribution plans are more attractive than defined benefit plans to employers for several reasons. First, there are fewer costs and administrative burdens associated with establishing and maintaining defined contribution plans than defined benefit plans. For example, in defined contribution plans there are no fees for actuarial services,<sup>23</sup> and no PBGC premiums for PBGC insurance.<sup>24</sup> Thus, defined contribution plans are an attractive alternative for the cost-conscious employer.

Second, more onerous regulations are imposed on employers who sponsor defined benefit plans than those who sponsor defined contribution plans. Over the last decade, changes to the laws governing private pensions have disproportionately affected defined benefit plans.<sup>25</sup> As a result, defined benefit plan sponsors find it necessary to amend their plans frequently to comply with complex new laws and regulations.<sup>26</sup> Burdensome regulation is often given as the

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22. The reallocation of risk has been manifested by not only an increase in the number of defined contribution plans but also a decrease in the number of defined benefit plans. See generally, Advisory Council: DOL Report Will Highlight Ongoing Shift in Pension Plans, 20 *Pens. & Ben. Rep. (BNA)* 2023 (Sept. 27, 1993). The shift towards defined contribution plans can also be seen in the changing composition of private primary plans. See EBRI Databook, *supra* note 19, at 139-45. There was a decrease of 56,651 in the number of private primary defined benefit plans between 1985 and 1990. See *id.* at 140. Meanwhile, between 1985 and 1990, the number of private primary defined contribution plans increased by 149,078. See *id.* However, most of this shift has taken place among small plans with two to nine participants. See *id.*

23. See Langbein & Wolk, *supra* note 5, at 274 (discussing actuarial fees and assumptions); see also generally Halperin, *supra* note 8, at 186-88.

24. The PBGC premium must be paid by all employers who maintain defined benefit plans. See generally Langbein & Wolk, *supra* note 5, at 93-94, 830-31, 854-55. For a discussion of the impact of the PBGC premium on the pension system's structure, see *infra* Part III.F.2.

25. See *Defined Benefit Plans: Employers Offer No Replacements in More Than One-Third of Terminations, Benefits Today*, Jul. 1992, at 223.

26. See Vineeta Anand, *IRS Cuts Some Slack on Retirement Rules*, *Pens. & Inv.*, Jan. 10, 1994, at 4; *Congress May Ruin the Party*, *Bus. Ins.*, Sep. 7, 1992, at 8; see also Keville, *supra* note 4, at 540. Another reason not discussed in the text above that employers may prefer

single most important reason underlying the recent shift to defined contribution plans.<sup>27</sup>

The reasons employees prefer defined contribution plans are different from those of the employer, and often relate to custom, flexibility, and participant involvement, rather than the inherent characteristics of the plan.<sup>28</sup> For example, defined contribution plans typically have more liberal vesting schedules than defined benefit plans.<sup>29</sup> Also, some defined contribution plans allow pre-separation distributions; others give participants control over the investment of their plan assets.<sup>30</sup>

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defined contribution plans is that the annual cost is not fixed in certain defined contribution plans, such as discretionary profit sharing plans or profit sharing plans with contribution formulas tied to profits. See Langbein & Wolk, *supra* note 5, at 42-43 (citing Peter T. Scott, A National Retirement Income Policy, 44 Tax Notes 913, 919-20 (1989)). Therefore, employers may have more flexibility in lowering their level of annual contribution during economic downturns. In contrast, the annual contribution to a defined benefit plan is determined by the experience of the plan with respect to employee turnover, death, and investment returns in a given year. *Id.* at 274. Thus, from year to year the employer's contribution to a defined benefit plan (which is generally not tied to profits) will fluctuate but cannot be decreased or increased at the employer's discretion. See Regina T. Jefferson, *Defined Benefit Plan Funding: How Much is Too Much?*, 44 Case W. Res. L. Rev. 1, 27 n.153 (1993). Even with funding flexibility, however, most plans are subject to the minimum funding rules to protect against underfunding. See 29 U.S.C. §§ 1081-86 (1999); IRC § 412; Langbein & Wolk, *supra* note 5, at 273. There are also caps under ERISA on deductible contributions to prevent tax manipulation through overfunding. See IRC §§ 404(a)(1)(A)(iii), 412.

27. The American Academy of Actuaries conducted a survey of employers that found that terminations of defined benefit plans are occurring in part, because of excessive government regulation. See Jerry Geisel, *Weighty Rules Crush Pension Plans*, *Bus. Ins.*, Mar. 22, 1993, at 3. For example, studies suggest that prolonged rulemaking by the IRS on the nondiscrimination requirements for defined benefit plans created too much uncertainty, and therefore contributed to the termination of around 40,000 small defined benefit plans between 1986 and 1993. Deirdre Fretz, *The IRS Redefines Benefit Plans*, *Inst. Investor*, Apr. 1993, at 149.

28. Another significant reason that defined contribution plans are often selected by employees as the plan type of choice is because the defined contribution plan structure is more advantageous to the more mobile members of the workforce with respect to the way it measures vested benefits. For example, if an employee terminates employment at age 35 after 10 years of service and the retirement benefit provided by the plan is 1% per year of service times final compensation, the participant would have earned 10% at the time of termination. In contrast, in a defined benefit plan, the contribution level anticipates a certain level of benefits based on estimated final pay; thus, the percentage of contribution and the accumulation at any given point will be greater than if no increase in pay were anticipated. See Halperin, *supra* note 8, at 185-86.

29. See IRC § 411 (providing minimum vesting standards for qualified plans); see also generally Langbein & Wolk, *supra* note 5, at 109-14. Although not required by the minimum vesting standards, the vesting standards have historically been more generous in defined contribution plans. *Id.* However, no rules prevent a defined benefit plan from being just as liberal in its vesting and distribution rules.

30. These plans are referred to as participant directed plans. See *infra* Part II.C.1; see

### C. Shortfalls in Defined Contribution Plans

Notwithstanding ERISA's general success in improving the funding and delivery of retirement benefits, several areas of current pension law are particularly inadequate in preventing shortfalls in defined contribution plans. First, in defined contribution plans, the fiduciary rules do not provide the same level of protection as they do in defined benefit plans. Historically, ERISA's fiduciary rules focused on employer mismanagement and the unauthorized use of plan assets.<sup>31</sup> In defined contribution plans, however, it is often the employee rather than the employer who makes the allocation and investment decisions regarding plan assets. In such plans, the employers' liability for poor investment performance as a plan fiduciary is reduced; consequently, many of the fiduciary rules are irrelevant for such plans.<sup>32</sup> Thus, participant involvement creates tension between individual choice and the retirement benefit protection provided by the fiduciary laws. On the one hand, participant involvement is desirable because it allows employees to be more active in the management of their retirement assets; on the other hand, when participants who lack financial expertise make investment decisions, their assets are often exposed to much greater risks.

A second reason defined contribution plan participants are more likely to experience shortfalls in their retirement benefits is because the insurance program for retirement plans has a gap in its insurance protection. As mentioned earlier, defined benefit plans are insured by the PBGC, whereas defined contribution plans are not. Defined contribution plans are not insured because there is a reluctance on the part of policymakers to insure investment

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also Michael J. Canan, *Qualified Retirement and Other Employee Benefit Plans* § 16.3, at 787-88 (1996 student ed.); Langbein & Wolk, *supra* note 5, at 50-51, 347-48; John J. McGrath, *Integration of Benefits and Allocation Formula*, 402 *PLI/Tax* 385, 414 (1997).

31. "Most of [ERISA's] fiduciary standards represent a codification of the common law of trusts." Elaine McClatchey Darroch, *Mertens v. Hewitt Associates: The Supreme Court's Dismantling of Civil Enforcement Under ERISA*, 1994 *Det. C.L. Rev.* 1089, 1092. The fiduciary standards were included in ERISA as a response by Congress to the "kickbacks, embezzlement, outrageous administrative costs, and excessive investments in the securities of plan sponsors/employers" discovered through Senate committee investigations in the 1950s. *Id.*

32. In some instances, the fiduciary rules have been used to provide only limited relief for fiduciary breaches in defined contribution plans. "If a participant . . . exercises control over the assets in his account, the fiduciaries of the plan will not be liable for any loss or for any breach of fiduciary duty which is the result of the participant's exercise of control." Joseph R. Simone & Glenn E. Butash, *Statutory Framework, "Language" and Fiduciary Responsibility Provisions of ERISA*, 385 *PLI/Tax* 7, 28 (1996) (footnotes omitted).

performance, as opposed to calculable retirement benefits.<sup>33</sup> Interestingly, the distinction between insuring investment performance and insuring calculable benefits is largely one of perception. Although insuring a minimum return in a defined contribution plan may appear problematic and incompatible with the existing defined benefit plan insurance model, a guarantee of a minimum investment return can be exactly what occurs in a defined benefit plan under current law.

The disparate treatment of investment performance in the two types of plans can be illustrated best by contrasting a traditional defined contribution plan, such as a profit sharing plan,<sup>34</sup> with a non-traditional cash balance plan.<sup>35</sup> The cash balance plan is a hybrid plan that has design features of a defined contribution plan, but in actuality is a defined benefit plan.<sup>36</sup> The cash balance plan promises benefits in the form of a hypothetical account which increases with annual pay credits and annual interest credits.<sup>37</sup> The pay credits are determined in the same manner as employer contributions are determined in a profit sharing plan.<sup>38</sup> Unlike the profit sharing plan, however, the cash balance plan guarantees an annual interest rate credit which is a proxy for investment earnings.<sup>39</sup>

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33. See *infra* Part III.D.

34. A profit-sharing plan is a plan which provides for the participation in the employer's profits by the employees. See Canan, *supra* note 30, at § 3.11, at 93. The plan must have a predetermined formula for distribution of contributions made to the plan among the participants at some fixed point in time, e.g., retirement or death. See *id.*

35. The cash balance plan operates very much like the profit sharing plan in terms of the contribution formula, but the retirement benefit itself is based on specific provisions of the plan document rather than the actual experience of each account. See Plan Administration: IRS Updating COBRA Regulations to Provide New Guidance, Consultant Says, 19 *Pens. & Ben. Rep. (BNA)* 592 (Apr. 6, 1992) [hereinafter COBRA]. In 1985, the cash balance plan was introduced by the Bank of America. The bank concluded that a defined contribution-like plan would be more effective than the social security offset pension plan it maintained at the time in giving more mobile workers a reason to ". . . stay one more year." However, switching to a defined contribution plan would have lowered benefits for senior employees approaching retirement age. A defined contribution plan also would have transferred the investment risk to all employees. Additionally, changing to a defined contribution plan would have required terminating the existing plan, and that could have had adverse tax consequences. Thus, the cash balance plan was created to allow Bank of America to achieve its goal without the problems that would result from switching to a defined contribution plan. Vincent Amoroso, *Cash Balance Plans*, 15 *Pens. & Ben. Rep. (BNA)* 339 (Feb. 22, 1988).

36. Amoroso, *supra* note 35, at 339. As a defined benefit plan, the cash balance plan is subject to the funding rules of IRC. See IRC § 412. See *infra* Part III.E. Contribution levels are determined using actuarial assumptions for investment earnings, turnover, and death. See John Fitzpatrick, *supra* note 9, at 78.

37. See COBRA, *supra* note 35, at 592.

38. The pay credits are not related to the plan asset levels. *Id.*

39. The interest rate credit is generally related to a nonstatic indicator, such as the yield on treasury instruments. Annuity benefits under a cash balance plan are determined by a formula that converts the account balance into a monthly benefit. Alternatively, participants may

In a cash balance plan, as with all other defined benefit plans, the employer, rather than the employee, assumes the primary investment risk. Thus, for example, if the cash balance plan assumes an interest return of ten percent, and the actual investment return is five percent, the employer would be responsible for the difference between the assumed rate of return and the actual experience of the plan.<sup>40</sup> If the employer were unable to make the additional contribution, the PBGC would be liable to the extent of the participants' vested accrued benefits.<sup>41</sup>

Therefore, in reality the PBGC does insure against the failure to earn the expected rate of return in defined benefit plans. Under similar circumstances, however, there would be no protection in a defined contribution plan. As a result, a defined contribution plan participant would experience a shortfall in her expected retirement benefit.<sup>42</sup>

Because the shift from traditional defined benefit plans to more flexible savings arrangements is more commonly accomplished by means of conventional defined contribution plans, such as money purchase plans and profit sharing plans rather than cash balance plans, protection against unfavorable investment returns will be unavailable for increasing numbers of participants in defined contribution plans.<sup>43</sup> As the use of hybrid plans such as cash balance plans expands, the continued reliance on plan classification to determine insurance protection eligibility will become increasingly confusing, and create more and more anomalous results. This situation is particularly disturbing since the cash balance plan is functionally similar to a defined contribution plan.

Insufficient funding of the expected retirement benefit is the third reason defined contribution plan participants may not receive the retirement benefits they expect. When a plan is established, a participant's projected retirement

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elect to receive lump-sum distributions when they terminate employment. Like defined contribution plans, cash balance plans provide greater benefits to employees who terminate employment before reaching retirement age. *Id.* Unlike the typical defined contribution plan, however, additional benefits in the event of disability, or death and ad hoc retirement increases can be made available in the cash balance plan. *Id.* Although the cash balance plan provides for optional form of payment as a lump sum, the PBGC does not guarantee the lump sum value of participants benefits; the PBGC guarantees only straight life annuity payments.

40. The cash balance plan falls within the broad coverage of ERISA § 4022 which provides that the PBGC shall guarantee the payment of all accrued benefits up to the limit under a single employer plan that terminates with insufficient assets. As a result, the cash balance plan is protected by the federal insurance program.

41. ERISA provides in pertinent part that the PBGC "guarantee[s] . . . the payment of all nonforfeitable benefits . . . under a single-employer plan which terminates at a time when [ERISA section 4021] applies to it." 29 U.S.C. § 1322(a) (1999).

42. See discussion *infra* Part III.D.

43. See discussion *infra* Part III.D; see also 29 U.S.C. § 1321(b)(1) (1999) (providing that protection is unavailable to individual account plans); Keville, *supra* note 4, at 556 (discussing the lack of PBGC protection for defined contribution plans).

benefit can be divided into two essential parts: (1) the portion attributable to the future; and (2) the portion attributable to the past. When newly established plans give credit for past service, the plans incur liabilities for prior years of service, although they have not accumulated any assets. Plans typically fund their initial past service liabilities over thirty-year periods.<sup>44</sup> Thus, assuming that there are no benefit increases and the actual assumptions are correct, if the plan continues to operate for at least thirty years, there is no risk of a funding shortage. If the plan terminates before the funding period has run, however, there may be insufficient contributions to cover the portion of the benefit attributable to past service.

Although defined contribution plans generally do not provide explicitly for past service, many of them do provide for such benefits implicitly.<sup>45</sup> However, because the PBGC fails to insure not only benefits attributable to future service in defined contribution plans, but also those attributable to past service, the past service benefit is not protected. Thus, defined contribution plan participants are more likely to experience shortfalls in both the past and future portions of their expected retirement benefits.

In defined contribution plans, just as in defined benefit plans, when shortfalls occur with respect to the past service benefit, it is because the employer fails to make sufficient contributions, not because unfavorable investment performance has occurred. Accordingly, in both types of plans the portions of the expected retirement benefit attributable to past service are equally insurable and pre-fundable. Therefore, even if one believes that there should be no protection in defined contribution plans of the portion of the expected retirement benefit attributable to future service because the benefit depends on future investment performance, one could view the portion of the retirement benefit based on past service credit very differently.

Because current pension law provides defined contribution plans inadequate protection, the shift from traditional defined benefit plans to more flexible defined contribution plans as primary retirement saving vehicles compromises ERISA's goal of guaranteeing the delivery of expected retirement benefits. This result is not inevitable, however. In order to provide the protection Congress intended to confer upon private pension plan retirees when it enacted ERISA, the fiduciary and funding laws should be amended. Additionally, insurance protection should be extended to all, or some portion, of the defined

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44. The serious underfunding of several large plans was caused by the 30-year funding period for past service credits. Thus, the Pension Protection Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330-33 (1987) (codified in scattered sections of 29 U.S.C.), required more rapid funding of underfunded plans due to concerns about the solvency of the defined benefit plan system. For more information on minimum funding standards, see 29 U.S.C. § 1082 (1999); IRC § 412(l).

45. See discussion *infra* Part IV.C.

contribution plan benefit, in order to prevent shortfalls in the expected retirement benefits of defined contribution plans.

This article explores the feasibility of each of these suggestions, and separately analyzes the impact of the following in defined contribution plans: (1) inadequate fiduciary rules; (2) unfavorable investment performance; (3) lack of insurance protection; and (4) inadequate funding practices. This article concludes that the impact of these risks is extremely disparate between defined benefit plans and defined contribution plans. Part II shows that inadequate fiduciary rules threaten the success of ERISA as the use of defined contribution plans as primary savings vehicles escalates. Part III demonstrates a need for insurance protection against unfavorable investment performance in defined contribution plans, and proposes an insurance model to resolve existing inequities among participants in the two types of plans. Part IV determines that past service credits in defined benefit plans and defined contribution plans are indistinguishable; consequently, at a minimum, the portion of the expected retirement benefit attributable to past service warrants pre-funding, or some level of insurance protection.

## II. THE PRIVATE PENSION PROGRAM AND THE FIDUCIARY LAW

### A. *Fiduciary Standards*

One of the primary goals of ERISA is to establish higher fiduciary standards in order to provide greater protection of retirement benefits.<sup>46</sup> Although ERISA has been relatively successful in achieving this goal, recent developments in fiduciary law threaten its success, potentially placing plan participants in a more disadvantageous position than they were in prior to the passage of ERISA.

Before ERISA, the state common law of trusts and the Internal Revenue Code governed a trustee's conduct in the administration and investment of pension assets.<sup>47</sup> Common law doctrine required the trustee "to make such

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46. See 120 Cong. Rec. S15,738, 15,741 (1974), reprinted in 1974 U.S.C.C.A.N. 4639, 5186-87 (statement of Sen. Williams).

47. Until 1974, the Internal Revenue Code's exclusive benefit rule, still in effect today, prescribed the only federal guidelines applicable to plan fiduciaries. The exclusive benefit rule provided that a plan would not qualify for preferential tax treatment if it was not maintained for the exclusive benefit of plan participants and their beneficiaries. IRC § 401(a). Historically, courts have not rigidly enforced the exclusive benefit rule, and the IRS has had a practice of not penalizing investments whose primary purpose is for the benefit of plan participants and their beneficiaries, in spite of their contemporaneous generation of collateral benefits for others. See *Shelby U.S. Distributions, Inc. v. Commissioner*, 71 T.C. 874, 885 (1979); Maria O'Brien Hylton, "Socially Responsible" Investing: Doing Good Versus Doing Well in an Inefficient Market, 42 *Am. U.L. Rev.* 1, 38 (1992); see also IRC § 404 (a)(1)(A)(i), (c)(1). For further discussion of the exclusive benefit rule, see Langbein & Wolk, *supra* note 5, at 649. An employee benefit plan fiduciary's behavior was also judicially reviewable under the Taft-Hartley Act. See Labor-

investments . . . as a prudent [person] would make of his own property."<sup>48</sup> The common law of trusts also imposed a duty of loyalty on the trustee and governed the remedies available to plan participants and their beneficiaries in the event of fiduciary breach.<sup>49</sup>

Currently, ERISA delegates to the federal government the duty of establishing all pension policy and law.<sup>50</sup> While ERISA preempts state law, including the state common law of trusts, ERISA's fiduciary standards are rooted in state common law tradition and pre-ERISA regulations. Like the common law, ERISA regulates fiduciary activities and protects pension assets from mismanagement, fraud, and bankruptcy. Under ERISA, a fiduciary's conduct is governed by the "prudent [person] rule,"<sup>51</sup> the general fiduciary standards of ERISA section 404, and the prohibited transaction rules of ERISA section 406.<sup>52</sup>

Commentators are in general agreement that Congress intended the prudent person rule to be applied more liberally under ERISA than was

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Management Relations Act (Taft-Hartley Act), Pub. L. No. 80-101, 61 Stat. 136 (1947) (codified as amended at 29 U.S.C. §§ 141-87 (1998)). The Act provided that multi-employer plans must be in the form of a trust arrangement. 29 U.S.C. § 186(c)(5) (1998). The Act provides federal jurisdiction for claims seeking enforcement of a collective bargaining agreement requiring maintenance or funding of an employee benefit plan. *Id.* at § 185(c). The Act was used to challenge fiduciary action under an arbitrary and capricious standard. This standard was incorporated into ERISA common law, but was modified by the Court. See Terese M. Connerton, *Suits by Beneficiaries Against Plans or Employers to Recover Benefits*, SB68 A.L.I.-A.B.A. 569, 614-15 (1997) (discussing *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101 (1989)). The Act was a "relatively weak and incomplete effort[] to regulate employee benefit plans." Catherine L. Fisk, *Lochner Redux: The Renaissance of Laissez-Faire Contract in the Federal Common Law of Employee Benefits*, 56 Ohio St. L.J. 153, 162 (1995).

48. Restatement (Third) of Trusts (Prudent Investor Rule) §181 (1992). *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446, first enunciated the traditional standard of the trust fiduciary, that the trustee act how "men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested." *Armory*, 26 Mass. (9 Pick.) at 461.

49. See Jeffrey A. Brauch, *The Danger of Ignoring Plain Meaning: Individual Relief for Breach of Fiduciary Duty Under ERISA*, 41 Wayne L. Rev. 1233, 1248 (1995) (discussing Justice Brennan's concurrence in *Mass Mutual Life Ins. Co. v. Russell*, 473 U.S. 134, 152-54 (1985), in which he argued that legislative history showed that Congress intended to incorporate into ERISA the fiduciary standards of the common law of trusts); see also Hylton, *supra* note 47, at 39.

50. See ERISA § 514(a), 29 U.S.C. § 1144(a) (1999).

51. The prudent man rule is codified at ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1) (1999). This rule provides that a fiduciary shall act "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." 29 U.S.C. § 1104(a)(1)(B) (1999).

52. ERISA §§ 404(a)(1), 406, 29 U.S.C. §§ 1104(a)(1), 1106 (1999).



customary at common law.<sup>53</sup> Nevertheless, plan fiduciaries must manage all activities with respect to the plan solely in a manner consistent with the best interests of plan participants and their beneficiaries.<sup>54</sup>

Under ERISA, plan fiduciaries are obligated to maximize investment returns. In doing so, they are permitted to take into consideration inherent risks associated with particular investments.<sup>55</sup> Thus, fiduciaries may accept lower investment returns in exchange for lower risks, or conversely, expose the assets to higher risks in exchange for the possibility of greater returns.<sup>56</sup> However, an overriding rule of fiduciary law is that the investor must always adequately diversify the investment portfolio in order to reduce the risk of investment losses.<sup>57</sup>

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53. See e.g., *Donovan v. Cunningham*, 716 F.2d 1455, 1467 n.26 (5th Cir. 1983) (holding that the flexible ERISA prudent man rule takes a facts and circumstances approach and does not incorporate the rigorous "prudent expert" standard of the common law); Hylton, *supra* note 47, at 39. See also Laurence B. Wohl, *Federal Duties Under ERISA: A Tale of Multiple Loyalties*, 20 U. Dayton L. Rev. 43, 53 nn.34-35 (1994); Jay Conison, *The Federal Common Law of ERISA Plan Attorneys*, 41 Syracuse L. Rev. 1049, 1135-36 (1990).

54. See 29 C.F.R. § 2550.404a-1; see also Dan M. McGill & Donald S. Grubbs, Jr., *Fundamentals of Private Pensions* 115-16, 442-44 (6th ed. 1989); see also Hylton, *supra* note 47 and accompanying text.

55. The Department of Labor takes the position that "economic considerations are the only ones which can be taken into account in determining which investments are consistent with ERISA standards." Ian D. Lanoff, *The Social Investment of Private Pension Plan Assets: May it be Done Lawfully Under ERISA?*, 31 Lab. L.J. 387, 392. In its evaluation of investment choices, the Department of Labor adopts an aggregate analyses which takes the entire investment portfolio into consideration rather than individual investments. See Paul J. Wessel, *Job Creation for Union Members Through Pension Fund Investment*, 35 Buff. L. Rev. 323, 340 (1986).

56. See Deborah M. Weiss & Marc A. Sgaraglino, *Prudent Risks for Anxious Workers*, 1996 Wis. L. Rev. 1175, 1198-1200. The Department of Labor has consistently rejected the common law approach to evaluating such investment choices with respect to a particular investment on the bases of using only the relative risk of the single investment. See Joseph R. Simone & Glenn E. Butash, *Statutory Framework, "Language" and Fiduciary Responsibility Provisions of ERISA*, 385 PLI/Tax 7, 27 (1996).

57. See Hylton, *supra* note 47, at 15, 17-18. Also see ERISA § 404(a)(1), 29 U.S.C. 1104(a)(1) (1994) (requiring that "a fiduciary shall discharge his duties . . . (C) by diversifying the investments of the plan so as to minimize the risk of large losses"); see also Hylton, *supra* note 47, at 16 (noting that "risk and return are positively correlated"). Diversification is a key method of reducing risk without reducing aggregate returns from a portfolio of assets. It exemplifies the old axiom: "Don't put all your eggs in one basket." Essentially, diversification is spreading investment funds into areas which will react differently to the market, thereby eliminating risk. See Richard J. Teweles et al., *The Stock Market* 386-87 (6th ed. 1992). "Diversification results from the interplay of three elements: (1) the number of different holdings; (2) the proportions in which different securities [or other assets] are held; and (3) the extent to which the securities [or other assets] held react in a dissimilar fashion to the same future contingencies." Janet E. Kerr, *Suitability Standards: A New Look at Economic Theory and Current SEC Disclosure Policy*, 16 Pac. L.J. 805, 817 (1985). A perfectly diversified

Historically, the fiduciary rules have been interpreted to provide greater protection to participants in defined benefit plans than in defined contribution plans.<sup>58</sup> One explanation for the different interpretations in the two types of plans is the level of employer involvement. In a defined benefit plan the employer determines the level of retirement benefit, who participates, and the manner in which the plan's assets are invested.<sup>59</sup> By contrast, in a defined contribution plan, it is often the employee who makes the decisions about participation, contribution, and asset management. Furthermore, because defined benefit plans have calculable retirement benefits, plan participants readily can determine whether a failure to provide promised retirement benefits is attributable to fiduciary breach. In defined contribution plans, benefits are based upon the participants' individual account balances and therefore indeterminate in nature. Thus, absent a showing of imprudent investment choices, a plan participant would have difficulty demonstrating fiduciary breach when account balances fall short of the expected retirement benefits.<sup>60</sup>

### B. *Fiduciary Breach Under ERISA*

ERISA defines a "fiduciary" as one with discretionary authority or control over pension plan assets, or one who manages pension assets.<sup>61</sup> Accordingly, employers, plan trustees, fund managers, and all other individuals who provide investment advice for profit are ERISA fiduciaries.<sup>62</sup> However, individuals who render professional services to a pension plan in a purely ministerial capacity are not considered fiduciaries.<sup>63</sup> ERISA does not expressly

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portfolio will eliminate nonmarket risk, leaving the assets to fluctuate according to the market. See *id.* at 818.

58. See Keville, *supra* note 4, at 547-48, 552.

59. Subject to the minimum participation standards of IRC § 411.

60. See discussion *infra* Part II.B.

61. IRC § 4975(e)(3); ERISA § 3(21)(A), 29 U.S.C. § 1002(21) (1999).

62. See e.g., *Blatt v. Marshall & Lassman*, 812 F.2d 810, 813 (2d Cir. 1987).

63. For example, actuaries, attorneys, accountants, and plan administration companies all have been held to be nonfiduciary third parties. See *Painters of Philadelphia District Council No. 21 Welfare Fund v. Price Waterhouse*, 879 F.2d 1146, 1149 (3rd Cir. 1989) (holding that performance of a standard audit did not make the accounting firm ERISA fiduciaries because the firm had no discretionary authority over management of the plan assets); *Pension Plan of Public Service Co. of New Hampshire v. KPMG Peat Marwick*, 815 F. Supp. 52, 55 (D.N.H. 1993) (holding that an accounting firm that provides typical auditing services to an ERISA plan was not an ERISA fiduciary); see Maria Linda Cattafesta, Note, *Mertens v. Hewitt Associates: A Narrow Interpretation of ERISA Precluding Nonfiduciary Liability for Money Damages Under ERISA*, 43 Cath. U.L. Rev. 1165, 1170 n. 23 (1994); *Anoka Orthopaedic Assoc. v. Lechner*, 910 F.2d 514, 517 (8th Cir. 1990) (holding that ministerial tasks performed for the purpose of collecting information was not a discretionary act and did not qualify the attorney as an ERISA fiduciary); *New York Teamsters Council Health and Hospital Fund v. Estate of De Perno*, 816

address or regulate the activity of those who are involved indirectly with the management of the plan's assets.<sup>64</sup> For example, investment managers are clearly ERISA fiduciaries, but it is unclear whether investment consultants are considered fiduciaries.<sup>65</sup> Thus, it is sometimes difficult to determine whether a service provider is acting in a fiduciary or ministerial capacity.<sup>66</sup>

Under ERISA, "[f]iduciaries who breach their fiduciary duties are personally liable to the plan to make good any resulting losses to the plan."<sup>67</sup> ERISA provides that equitable or remedial measures shall be awarded as a court deems appropriate.<sup>68</sup> Historically, the beneficiary of a pension trust could maintain an equitable suit for damages against not only a fiduciary for breach of trust, but also against a participating non-fiduciary.<sup>69</sup> Thus, even though fiduciaries and participating non-fiduciaries were subject to different standards of care, there were remedies available against both, in the event of a breach of trust.

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F. Supp. 138, 148 (N.D.N.Y. 1993); see *Cattafesta*, supra, at 1170 n.22; *Pappas v. Buck Consultants, Inc.*, 923 F.2d 531, 538 (7th Cir. 1991) (holding that an actuary who performs usual actuarial services is not an ERISA fiduciary); *Fechter v. Connecticut General Life Ins. Co.*, 798 F. Supp. 1120, 1125 (E.D. Pa. 1991) (same); see *Cattafesta*, supra, at 1169-70 nn.20-21; *Pohl v. National Benefits Consultants, Inc.*, 956 F.2d 126, 128-29 (7th Cir. 1992) (holding that the performance of clerical, mechanical, and ministerial services did not confer discretionary authority over the plan administrator, and thus, the plan administrator was not an ERISA fiduciary); *Baxter v. C.A. Muer Corp.*, 941 F.2d 451, 454-55 (6th Cir. 1991) (holding that a plan administrator who performed claims processing services was not an ERISA fiduciary); see *Cattafesta*, supra, at 1170 n.23. But see *Bouton v. Thompson*, 764 F. Supp. 20, 23 (D. Conn. 1991) (holding that an attorney who exercises discretionary control over the management of plan assets is an ERISA fiduciary).

64. See ERISA § 3(14)(A), 29 U.S.C. §§ 1002(14)(A), 1101-1114 (1999).

65. See Joel Chernoff, *Hewitt Decision Challenged*; Metzbaum, *Labor Department Fight High Court Ruling*, *Pens. & Inv.*, Jun. 14, 1993, at 229. Case law regarding other service providers gives the only guidance in this area. See *Custer v. Sweeney*, 89 F.3d 1156, 1161-63 (4th Cir. 1996) (holding that plan's attorney is not ERISA fiduciary); *United States v. Coyle*, 63 F.3d 1239, 1246-47 (3d Cir. 1995) ("by providing medical services to the Fund," AMMA is a fiduciary under ERISA); see also Andrew T. Kusner, *Mertens v. Hewitt Associates*, and the ERISA Liability of the Professional Service Provider, 15 *Berkeley J. Emp. & Lab. L.* 273, 304-05 (1994).

66. See *Mertens v. Hewitt Associates*, 508 U.S. 248, 262-63 (1993).

67. Michael J. Canan & William D. Mitchell, *Employee Fringe and Welfare Benefit Plans* § 16.5 (1994 ed.).

68. See ERISA § 502(a)(3), 29 U.S.C. § 1132(a)(3)(B) (1998); see Roger C. Siske et al., *What's New in Employee Benefits: A Summary of Current Case and Other Developments*, SB66 A.L.L.-A.B.A. 1, 13-36 (1997).

69. *Cattafesta*, supra note 63, at 1191. The Supreme Court in *Mertens* defined "equitable relief" as "injunction, mandamus, and restitution." *Mertens*, 508 U.S. at 248. Equitable relief is, in fact, remedies awarded that are not monetary. See *Black's Law Dictionary* 539 (6th ed. 1990).

However, in *Mertens v. Hewitt*, the Supreme Court interpreted section 502(a)(3) of ERISA as precluding nonfiduciary liability in the event of breach.<sup>70</sup> The Court held that ERISA does not provide monetary relief against participating nonfiduciary third parties, even when they knowingly participate in fiduciary breaches.<sup>71</sup> The *Mertens* Court reasoned that because ERISA mandates specific remedies and “allocates liability for plan-related misdeeds in reasonable proportion to [the] respective actors’ power to control and prevent the misdeeds,” the provision of monetary relief against service providers who performed services in the capacity of nonfiduciaries was unavailable.<sup>72</sup> The Court explained that professional service providers lacked the requisite fiduciary control, and became “liable for damages [ONLY] when they cross the line from advisor to fiduciary.”<sup>73</sup>

The *Mertens* Court was concerned that exposing service providers to full liability for fiduciary breach would result in higher insurance costs for persons who regularly provide advisory services to ERISA plans.<sup>74</sup> To do so, they feared, ultimately would increase the costs for ERISA plans. In other words, the Court believed that money that otherwise would be used for retirement benefits would be used to pay for indemnification against potential litigation. Thus, the *Mertens* Court preferred to limit the remedies against service providers to court injunctions, or restitution of fees, rather than to hold them liable for restoring losses resulting from their participation in fiduciary breaches.<sup>75</sup>

Interestingly, the common law of trusts accords participants and their beneficiaries a cause of action for monetary damages against nonfiduciaries who knowingly participated in fiduciary breaches.<sup>76</sup> Thus, under pre-ERISA trust law, wealthy nonfiduciaries were discouraged from participating in fiduciary breaches fearing that they could be alternative financial resources to subsidize lost retirement benefits. For this reason, many commentators characterize the Court’s restrictive interpretation of ERISA’s fiduciary law in the *Mertens* decision as regressive.<sup>77</sup>

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70. See *Mertens*, 508 U.S. at 254.

71. *Id.*

72. *Id.* at 262.

73. *Id.*

74. *Id.*; see also Chernoff, *supra* note 65, at 3 (discussing the *Mertens* opinion).

75. See *Mertens*, 508 U.S. at 262.

76. See Kusner, *supra* note 65, at 280-81 (discussing how some circuits relied on pre-ERISA trust law to reach an interpretation of ERISA §502(a) different than the Supreme Court did in *Mertens*).

77. See, e.g., Kusner, *supra* note 65; Dana M. Muir, ERISA Remedies: Chimera or Congressional Compromise?, 81 Iowa L. Rev. 1 (1995); Gregory A. Hewett, Should Non-Fiduciaries Who Knowingly Participate in a Fiduciary Breach Be Liable for Damages Under ERISA?, 71 Wash U. L.Q. 773 (1993). The dissent in *Mertens* argued that both equitable and legal remedies were available under the common law of trusts to ensure that beneficiaries

The Court's holding that nonfiduciary service providers are immune from fiduciary liability is potentially more devastating to defined contribution plan participants than to defined benefit plan participants. In defined benefit plans, if the remedies against third party non-fiduciaries are inadequate, the minimum retirement benefit is, nevertheless, guaranteed by the employer and the PBGC.<sup>78</sup> Participants, therefore, do not face the risk of insufficient asset accumulation as a result of third party involvement in fiduciary breaches. Thus, diverting pension assets to provide a broader range of remedies against nonfiduciaries in defined benefit plans could be considered unnecessary or inefficient. Consequently, the Supreme Court's reluctance to have pension assets diverted for service provider indemnification can be understood in the defined benefit plan context.

In contrast, however, because there is neither employer liability nor PBGC protection in defined contribution plans, defined contribution plan participants have no protection against shortfalls. Therefore, if a defined contribution plan in which the fiduciary is unable to respond, terminates with insufficient asset accumulation due to third party fiduciary breach, and the remedies against the third party are inadequate to fully restore the lost benefits, the plan participants will bear the brunt of the loss.<sup>79</sup> Defined contribution plan participants are, thus, exposed to much greater risks when service providers contribute to plan losses than defined benefit plan participants. Accordingly, the use of retirement funds to indemnify service providers in connection with a broadening of the remedies against third parties, could be reasonably considered an efficient use of defined contribution plan assets, because plan participants

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received complete relief. See *Mertens*, 508 U.S. at 264-66. Moreover, the dissent concluded that the phrase "appropriate equitable relief" used in ERISA § 502(a)(3) implicitly includes all remedies available under equity for breaches which include monetary damages against both fiduciaries and nonfiduciaries alike. *Id.* at 266-67. The dissent's interpretation would give plan participants and their beneficiaries the same protection under ERISA that they would have had before the enactment of ERISA. See *id.* *Mertens* states in dicta that there is no cause of action against a nonfiduciary for knowingly participating in a fiduciary's breach of duty under ERISA. See *Remedies: Seventh Circuit Finds No Claim Against Nonfiduciary, Cites Mertens*, 21 *Pens. & Ben. Rep. (BNA)* 1675, 1675 (Aug. 29, 1994). Chief Judge Posner and the Seventh Circuit followed this "considered dictum" while holding that there is no cause of action against a nonfiduciary who knowingly participates in a fiduciary's breach of duty under ERISA. *Reich v. Continental Casualty Co.*, 33 F.3d 754, 757-58 (7th Cir. 1994). The First Circuit has also followed *Mertens*'s lead in holding that equitable remedies are not available against nonfiduciaries who knowingly participate in a fiduciary's breach of duty. See *Reich v. Rowe*, 20 F.3d 25 (1st Cir. 1994).

78. See *infra* Part III.A.

79. If a retirement plan is not covered by Title I of ERISA, the participant will have remedies available under state law, including money damages and injunctive relief. See *Canan*, *supra* note 30, at § 21.2, at 1024-25.

otherwise have inadequate protection.<sup>80</sup> Thus, the *Mertens* holding is less understandable in the defined contribution plan context, where participants are exposed to greater risks of loss when third parties make investment decisions, or are involved in the management of plan assets.<sup>81</sup>

### C. *The Fiduciary Rules and Participant Directed Plans*

Although employers who sponsor defined contribution plans are not required to allow participants to make individual participation and investment decisions, many employers recognize that giving flexibility enables employees to customize their retirement programs to accommodate specific saving objectives and risk tolerances.<sup>82</sup> Thus, growth in the defined contribution plan area has been driven largely by the establishment of participant directed plans.<sup>83</sup> Participant directed plans cover approximately 25 million employees, and represent the fastest growing component of the private sector retirement system.<sup>84</sup> In participant directed plans, employees decide not only whether to participate, and the level of compensation to be contributed to the plan by the employer on their

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80. Immediately after *Mertens* was decided, the Department of Labor sought to persuade Congress to amend ERISA to assign fiduciary responsibility to anyone directly or indirectly involved in the management of pension assets. The Senate Labor Committee drafted an amendment to ERISA that explicitly made service providers liable for monetary damages if they "knowingly participate[d]" in fiduciary breaches. Chernoff, *supra* note 65, at 1. Senator Howard Metzenbaum, with input from the Department of Labor, drafted the amendment to reverse the Supreme Court's *Mertens* decision. See Chernoff, *supra* note 65, at 2. The amendment was later defeated. *Id.*

81. See *infra* Part II.C.

82. Employees often are asked to decide whether they will participate in the plan, how much to contribute to the plan from current compensation, how their funds should be invested within choices offered by the employer, and finally, whether to roll over lump sum distributions received from the plans on termination of employment. See Keville, *supra* note 4, at 549-51. Interestingly, the reason most employers allow participants to make these decisions is a general misconception about ERISA. Basically, employers who sponsor qualified plans are convinced that ERISA § 404(c) protects them from any potential liability arising out of the investment returns experienced in a participant's account if they only transferred investment responsibility for the account to the participant. See Jeffrey M. Miller, *Employer-Directed Plans May Be the Answer*, *Pension Mgmt.*, Nov. 1994, at 30.

83. Participant directed plans are typically 401(k) plans; however, other defined contribution plans also may give participants the responsibility of choosing how the plan assets are to be invested. In addition to the self-directed feature, 401(k) plans often require participants to make numerous other decisions about their retirement security.

84. Marlene Givant Star, *Participants in a Quandry About Plan Options*, *Pens. & Inv.*, Oct. 17, 1994, at 19. The number of participant directed 401(k) plans has grown rapidly. Participation in such plans increased by approximately 45% from 1983 to 1993, attributable in large part to the creation of new retirement plans by small businesses. See Canan, *supra* note 30, at §16.3, at 788.

behalfes, but also the manner in which their accounts are to be invested.<sup>85</sup> In such plans, the individual decisions made by plan participants ultimately determine the adequacy of the retirement benefit.

Notwithstanding the significance of the investment decisions, however, ERISA currently imposes no additional notification or education requirements on employers who sponsor participant directed plans. ERISA's general fiduciary standards govern the plan's notification and investment practices. Thus, participant directed plans raise an additional question about the adequacy of ERISA's fiduciary rules. Is it appropriate to allow employers to shift the responsibility of making critical investment decisions to plan participants, who typically lack professional financial training?<sup>86</sup> Section 404(c) safe harbor plans (discussed below) raise even more concerns regarding the adequacy of ERISA's fiduciary rules because under such plans, the employer and other plan fiduciaries are almost completely insulated from fiduciary liability for the poor investment decisions made by plan participants.

1. *Investment Practices and Participant Directed Plans.*—In employer directed plans, a plan administrator or an investment professional typically controls the plan investments.<sup>87</sup> The investment manager is required to allocate investments in a manner that offers protection against inflation, market fluctuations, and unfavorable market performance.<sup>88</sup> In participant directed plans, the same investment strategy is desirable, but generally not utilized because employees often have not had sufficient investment training to achieve this result.<sup>89</sup>

The modern portfolio theory of investment explains that an adequately diversified portfolio should include an appropriate balance of stocks, bonds, and stable valued funds.<sup>90</sup> However, inexperienced participants generally fail to adequately diversify their retirement accounts, investing disproportionately in stable value funds.<sup>91</sup> Because a balanced investment portfolio provides a better

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85. The investment choice is made among the investment options offered by the employer.

86. See Mary Rowland, Taking the Power of the 401(k), and Handing it to Someone Else, N.Y. Times, June 18, 1995, at F5 (stating that some plan participants have recognized their own inadequacies regarding investment management and have turned their retirement accounts over to outside stockbrokers).

87. See Keville, *supra* note 4, at 543-44.

88. Diversification is Key to Success of Section 401(k) Investments, ASPA Told, 17 Pens. & Ben. Rep. (BNA) 1243 (July 16, 1990) [hereinafter *Diversification*].

89. Insufficient financial training has been cited most frequently as the explanation for why participants use overly conservative investment strategies. *Id.* at 1243.

90. See J. Michael McGowan, Watching Your Basket: Keys to Nurturing a Successful Investment Portfolio, 78 A.B.A. J. 97 (Nov. 1992).

91. *Diversification*, *supra* note 88, at 1243.

relationship between return and risk, the failure to adequately diversify investment portfolios adversely affects retirement income security. A high concentration of stable value, low-yield investments generally produces insufficient investment income over one's working life to provide financial security for the retirement years.<sup>92</sup> Consequently, a participant who disproportionately invests in stable valued instruments would have to save greater amounts to be in the same position at retirement as a participant who sufficiently diversified their investment portfolio.<sup>93</sup>

Not only are inexperienced investors likely to inadequately diversify their retirement portfolios, but they also are less likely to recognize the financial indicators on which investment professionals rely to know when to transfer funds from one investment to another.<sup>94</sup> Therefore, inexperienced investors may fail to make appropriate changes when such transactions are warranted. Under other circumstances, inexperienced investors may act too hastily.<sup>95</sup> For example, during market down-swings, undisciplined investors may abandon high-risk, high-return investments too quickly, notwithstanding conventional wisdom that these investments perform best over the long-run.<sup>96</sup>

If inexperienced participants do not, or cannot, make good investment decisions, they will have insufficient accumulation when they retire. Younger employees are particularly vulnerable to less than optimal investment practices because the compounding of their returns will occur over longer periods of time. Thus, the success or failure of participant-directed plans hinges on the proper education and notification of plan participants in areas of asset allocation, diversification, and risk return.<sup>97</sup>

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92. Overly conservative investment strategy is problematic for two other reasons: First, inflation, although averaging only 4% over the last decade, is a potential threat to the purchasing power of retirement income. Second, as life expectancies continue to increase, assets that participants have accumulated in their defined contribution plan accounts will need to stretch farther. Alexander Sussman, *The Investment Horizon: How Can Employers Assure Adequate Retiree Benefits in the Coming Years?*, *Comp. & Ben. Rev.*, Jan. 1, 1996, at 73.

93. See Regina T. Jefferson, *The American Dream Savings Account: Is it a Dream or a Nightmare?*, *Taxing America* 261 (Karen B. Brown & Mary Louise Fellows eds., 1996).

94. See Keville, *supra* note 4, at 545-46 (noting that "the majority of self-directed pension plan investors transferred funds to the stock market after it reached its high in 1987, and bailed out after the market crashed soon thereafter").

95. Participants in 401(k) plans are active traders, contrary to popular belief. These investors may panic during market fluctuations, selling too quickly, which ultimately could threaten their financial security. See Vanessa O'Connell, *Market Bumps Rattle Nerves at 401(k)s*, *Wall St. J.*, Aug. 23, 1996, at C1.

96. See Judy Greenwald, *Investment Education Raises Employer Liability Questions: When Does Information Become Advice?*, *Bus. Ins.*, Oct. 31, 1994, at 2, 98.

97. See James E. Graham, *Does 404(c) Provide More Questions Than Answers?*, *Pension World* (July 1994) at p. 48.



2. *The Education and Notification Requirement in Participant Directed Plans.*—ERISA’s mandate of “fiduciary responsibility” for plan trustees, investment managers, and other persons who control pension plans, makes all plan fiduciaries ultimately responsible for asset performance in retirement plans.<sup>98</sup> Thus, in participant directed plans, the employer remains liable as an ERISA fiduciary, although the participant makes the investment choices.<sup>99</sup> Consequently, it is possible for the participant who loses money as a result of inadequate investment diversification to bring a cause of action against the employer, on the grounds that the availability of the transaction implied approval of the investment choice. Alternatively, a participant could argue that the employer should have recognized a problem with the investment decision, and overruled the allocation. Although a participant would have tremendous difficulty meeting the burden of proof for such allegations, the employer or plan fiduciaries, nevertheless, would be liable for the investment losses if the participant were successful.<sup>100</sup>

To minimize their potential liability for poor investment decisions made by plan participants, many employers have established education programs.<sup>101</sup> Providing investment education presents a catch twenty-two for the employer, however. On the one hand, employers can be held liable if they do not provide sufficient investment information to enable plan participants to make sound investment decisions. On the other, they can be held liable for losses as plan

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98. See Munnell, *supra* note 11, at 137; see also *supra* Part II.B. There is an exception for § 404(c) plans in which the plan fiduciaries are not responsible for the investment decisions made by plan participants. See *infra* Part II.C.3.

99. This is true even in § 404(c) plans in which the employer’s liability is significantly minimized. See *infra* Part II.C.3.

100. In participant directed defined contribution plans the fiduciary standards would most likely be applied less strictly than in other types of defined contribution plans. Fiduciaries of such plans are apparently obligated to exercise only procedural prudence regarding investment decisions. Therefore, successful participant claims regarding poor investment performance are essentially eliminated in participant directed accounts. To establish fiduciary breach or mismanagement in a participant directed plan, participants would be limited to showing either that they were not advised properly, that there were not broad enough investment choices, or that there were inappropriate investment alternatives. Miller, *supra* note 82, at 30. For a discussion of participant directed plans, see *supra*, Part II.C.1.

101. See Thomas R. Hoecker & Nancy K. Campbell, *Participant Directed Investment Plans—Problems and Solutions*, Q245 A.L.I.-A.B.A. 211 (1996); see also EBRI Releases Report on Participant Education for Improved Retirement Savings, 95 Tax Notes Today 86-51 (May 3, 1995) [hereinafter EBRI Releases]. A survey by EBRI and Matthew Greenwald and Associates indicated that 73% of 401(k) participants received some type of educational material from their employer. *Id.* Among the 73% that received the material, 33% increased the amount of their contribution and 44% changed the allocation of their money. *Id.*

fiduciaries if the information is considered investment advice, and later proves to be incorrect.<sup>102</sup>

The Department of Labor Regulations explain that "investment advice" consists of recommendations pertaining to property value; "investment information" consists of mere communication that is general in nature.<sup>103</sup> Accordingly, providing a list of investment vehicles and instructions about the investment selection process is likely to be considered mere communication. Whereas, specific recommendations about particular investments are likely to constitute investment advice.<sup>104</sup>

Until recently, employers were counseled that providing bad investment advice was a greater risk than providing insufficient investment information.<sup>105</sup> In other words, employers were more exposed to litigation when they established education programs than when they allowed participants to make their investment decisions without the benefit of financial training.<sup>106</sup> Because employers are typically unwilling to assume a risk of greater exposure to potential liability, it

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102. See Mary Rowland, *Educate-or Litigate: Educating Pension Plan Participants*, *Inst. Inv.*, March 1, 1995, at 87. If the information is considered investment advice, those providing the information, e.g., employers, plan sponsors, service providers, would be deemed fiduciaries, subject to liability under ERISA. See Frederick C. Kneip, Section 404(c): Basic Principles, 397 *PLI/Tax* 43 (1997); See also Roger C. Siske et al., *What's New in Employee Benefits: A Summary of Current Cases and Other Developments*, SB66 *A.L.L.-A.B.A.* 1, 78-79 (1997).

103. The Department of Labor has determined that "[a]n investment advisor who suggests investment alternatives for a pension plan has a definite fiduciary duty to select alternatives prudently." Keville, *supra* note 4, at 551-52. Keville also notes that "an investment advisor who is hired by an employer to provide investment instructions to employees is a fiduciary under the terms of ERISA if the advisor is compensated for services rendered." *Id.*

104. See Keville, *supra* note 4, at 551-52. However, any individual giving investment information to plan participants may be considered a fiduciary if it reasonable for the participant to consider the information investment advice and if the participant acts accordingly to her detriment. Jack W. Murphy, Associate Director and Chief Counsel of the Division of Investment Management at the SEC stated that an employee sponsor providing information would not be considered to be giving advice unless it held itself out as providing advice or received additional compensation from employees or third parties for the advice. See *Division of Investment Management the Year in Review: Regulation of Investment Companies, Investment Advisors and Public Utility Holding Companies in 1996*, 979 *PLI/Corp* 7, 680 (Feb.-Mar. 1997).

105. See Rowland, *supra* note 102, at 87. See also Jeffrey M. Miller, *The Difference Between Education and Advice*, *Pension Mgmt.*, Feb. 1995, at 34. If plan sponsors teach participants about investment performance in achieving long-term retirement goals, the sponsor will not be considered a fiduciary. *Id.* However, if the sponsor creates programs which provide the basis for participants' investment decisions, plan sponsors may be regarded as fiduciaries which exposes them to potential liability. *Id.* In this situation, sponsors will have crossed the line between providing investment information and advice. *Id.*

106. See Rowland, *supra* note 102, at 87; see also Miller, *supra* note 105, at 30 (noting that in the 1980's, employers thought they could avoid liability altogether by transferring the investment responsibility to plan participants).

is not surprising that many employers have not provided adequate investment education to their employees.<sup>107</sup> As a result, employees participating in participant-directed plans are often left on their own to obtain the education and training necessary to successfully manage their retirement savings.

The significance of the distinction between investment advice and investment information is another reason the *Mertens* decision is more troubling for certain defined contribution plan participants than for defined benefit plan participants. In participant-directed defined contribution plans, unsophisticated investors unable to distinguish between investment advice and investment information may suffer unfortunate consequences as a result of misunderstandings. If an investment broker aggressively markets alternative investments under the rubric of investment information, inexperienced plan participants could interpret the broker's comments as specific recommendations, rather than general information. Believing that they have received investment advice, participants may rely on the communication and make decisions that adversely affect the build-up of their accounts. Under *Mertens*, money damages would be unavailable to the plan participants in this situation, even if the broker had adequate assets to restore plan losses.<sup>108</sup> Thus, the participants ultimately would receive smaller retirement benefits than expected.<sup>109</sup>

3. *Section 404(c) Plans.*—Another method of minimizing liability for poor investment performance is for the employer to adopt a section 404(c) plan.<sup>110</sup> An employer's exposure to fiduciary liability is substantially reduced if

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107. See Rowland, *supra* note 102, at 87. Recent numbers suggest that there has been an increase in education programs offered by employers. However, many employers make such programs available because it is important for them to encourage low and middle income employees to participate in elective contribution plan. See EBRI Databook, *supra* note 19. However, with the introduction of the new safe harbor rules for nondiscrimination in 401(k) plans many employers may discontinue these programs.

108. See *supra* Part II.B. The only chance for the participant to receive money damages is for her to demonstrate that she reasonably interpreted the comments as investment advice. An investment advisor who directs participant investment selections for a pension plan has a fiduciary duty to select alternatives prudently. See Keville, *supra* note 4, at 548-52.

109. A cause of action may be available under common law, however. See *infra* Part III.A.

110. ERISA § 404(c), 29 U.S.C. § 1104(c) (1999). This section provides: (c)(1) In the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over assets in his account, if a participant or beneficiary exercises control over the assets in his account (as determined under regulations of the Secretary)- (A) such participant or beneficiary shall not be deemed to be a fiduciary by reason of such exercise, and (B) no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant's

the plan complies with the rules and regulations of section 404(c), "safe harbor" plans.<sup>111</sup> These rules require the employer to give a broad range of investment options, and reasonable instructions regarding the significance of the options.<sup>112</sup>

Unlike traditional participant directed plans in which plan fiduciaries retain some obligation to make sure that the plan assets are protected against losses, section 404(c) safe harbor plans essentially shield the employer and other plan fiduciaries from any liability.<sup>113</sup> Regardless of how plan participants allocate

or beneficiary's exercise of control.

Id. Section 404(c) of ERISA is elective and applies only to defined contribution plans, such as 401(k) plans, where participants control the investment of their assets. Id.

111. 29 C.F.R. § 2550.404c-1 (2000). The § 404(c) regulations were issued in October of 1992. 57 Fed. Reg. 46932 (1992). The regulations define an ERISA § 404(c) plan as, generally, a defined contribution plan that provides participants with the opportunity to "exercise control over assets" in their accounts and provides the participant with "an opportunity to choose from a broad range of investment alternatives." 29 C.F.R. § 2550.404c-1(b)(1)(i), (ii) (2000). See also Canan, *supra* note 30, at §16.3, at 788-89. However, § 404(c) relief is not available in transactions where a plan fiduciary has exercised improper influence or concealment of material nonpublic facts known by the fiduciary, or takes instructions from a participant that is known by the fiduciary to be legally incompetent. 29 C.F.R. § 2550.404c-1(c)(2) (2000).

112. See Canan *supra* note 30, at § 16.3, at 791-93. A broad range of investment alternatives means:

(I) A plan offers a broad range of investment alternatives only if the available investment alternatives are sufficient to provide the participant or beneficiary with a reasonable opportunity to:

(A) Materially affect the potential return on amounts in his individual account with respect to which he is permitted to exercise control and the degree of risk to which such amounts are subject;

(B) Choose from at least three investment alternatives:

- (1) Each of which is diversified;
- (2) Each of which has materially different risk and return characteristics;
- (3) Which in the aggregate enables the participant or beneficiary by choosing among them to achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the participant or beneficiary; and
- (4) Each of which when combined with investments in the other alternatives tends to minimize through diversification the overall risk of a participant's or beneficiary's portfolio;

(C) Diversify the investment of that portion of his individual account with respect to which he is permitted to exercise control so as to minimize the risk of large losses. . . .

29 C.F.R. § 2550.404c-1(b)(3) (2000).

113. See Investments: Pension Plan Participants Need Education on Investments, Group Told, 21 *Pens. & Ben. Rep. (BNA)* 775 (Apr. 18, 1994). However, § 404(c) compliance does not shield the employer from all fiduciary liability. Plan fiduciaries are still accountable for making certain that the investment options offered are sound and the investment managers

their assets in such plans, plan fiduciaries are not liable for any losses that result from poor investment returns.<sup>114</sup> These plans, therefore, place the entire risk of accumulating insufficient assets from poor investment decisions on the participants.<sup>115</sup>

As is the case in traditional participant directed plans, the employer who sponsors a section 404(c) safe harbor plan has no obligation to assist participants in making their investment decisions. Furthermore, as discussed above, the employer is discouraged from doing so because such assistance could trigger fiduciary liability in plans that are otherwise in compliance with section 404(c).<sup>116</sup> Therefore, participants in safe harbor plans have little or no recourse against employers, administrators, or service providers for investment losses.<sup>117</sup> They are barred from claiming that the employer either should have recognized a problem, or provided different investment options.<sup>118</sup> In traditional participant directed plans, these allegations might be successful on the grounds that a failure to diversify the participant's account violates ERISA's prudence and diversification rule.<sup>119</sup>

#### D. Pension Policy and Participant Directed Plans

Employers prefer participant directed plans because they are more convenient and less costly to maintain than other plans, and some employers establish these plans in efforts to minimize their liability for investment decisions.<sup>120</sup> Employees typically prefer participant-directed plans because they

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selected are competent. See 29 C.F.R. § 2550.404c-1(a)(2) (2000). See also Rowland, *supra* note 102, at 87-88; Keville, *supra* note 4, at 549.

114. See Frederick C. Kneip, Section 404(c): Basic Principles, 397 PLI/Tax 43, 46-48 (May 1997).

115. See Canan, *supra* note 30, at § 16.3, at 793; see also Greenwald, *supra* note 96, at WL p. 2-3; 29 C.F.R. § 2550.404c-1(b)(1), (2) (2000).

116. See also *supra* Part II.C.2; Keville, *supra* note 4, at 551-52.

117. See ERISA § 404(c)(2), 29 U.S.C. § 1104(c)(1)(B) (1999) (providing that a fiduciary is not liable for a loss resulting from the exercise of control by a participant or beneficiary); 29 C.F.R. § 2550.404c-1(d)(2)(i) (2000) (providing that when independent control over the assets is exercised by a participant or beneficiary, the fiduciary is not responsible for any loss that is the direct and necessary result). However, there remains some liability for the employer. See Kneip, *supra* note 114, at 69-70.

118. See Hoecker & Campbell, *supra* note 101, at 213; but see 29 C.F.R. § 2550.404c-1(d)(2)(ii)(A)-(E) (2000) (providing that § 404(c)'s limit on fiduciary liability will not be available if, for example, the participant's decision would violate provisions in the plan documents).

119. See Weiss & Sgaraglino, *supra* note 56, at 1213; Patricia Wick Hatamyar, *See No Evil? The Role of the Directed Trustee Under ERISA*, 64 Tenn L. Rev. 1, 18-19 (1996); see also *supra* Part II.A.

120. See *supra* Part I.B.

believe that the plan's flexibility can provide greater long term rewards, if they make wise investment decisions.<sup>121</sup> However, it is not uncommon for plan participants to have inflated opinions about their investment expertise.<sup>122</sup> Thus, rather than increasing their retirement income security, participant directed plans, in reality, may decrease the retirement income security of those who are inexperienced in financial investment.

This is particularly true as the emergence of new products and services makes investment decision making more difficult. For example, some plans allow participants to execute trades on a daily, rather than monthly basis.<sup>123</sup> Other plans provide broad ranges of options that include the entire universe of publicly traded stock.<sup>124</sup> Expansive measures such as these are increasingly offered, although the complexity of the limited investment options previously available to plan participants was well beyond the understanding of the average investor.<sup>125</sup>

The popularity of participant directed plans does not necessarily stem from the fact that they are the best way to maximize retirement income security, however. Rather their popularity stems from the fact that they are what both employers and employees seemingly prefer.<sup>126</sup> Despite their overwhelming popularity, participant directed plans present a very difficult trade-off.<sup>127</sup> Employees are given greater flexibility and autonomy in making investment decisions, but they are also exposed to greater risks of investment losses. Moreover, as employers increasingly establish participant directed plans, undoubtedly more of them will turn to safe harbor plans that provide even less protection for plan participants, in order to avoid unwanted exposure to fiduciary liability.<sup>128</sup>

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121. See Star, *supra* note 84, at 19.

122. Two thirds of participants surveyed in a study conducted by Buck Consultants of New York and Phoenix Hecht of the Research Triangle in North Carolina, preferred to manage their own assets. See Star, *supra* note 84, at 19; Jan M. Rosen, *Self-Directed Retirement Plans*, N.Y. Times, Dec. 1, 1990, at A1.

123. See Brian E. Schaefer, *The Trouble With Daily Switching for 401(k)s*, *Pens. & Inv.*, March 6, 1995, at 12; see also Star, *supra* note 84, at 19. When plans allow fund switches on a daily basis, it may cause participants to play the market, producing inferior results in the long run.

124. See Schaefer, *supra* note 123, at 12.

125. See Star, *supra* note 84, at 19 (explaining that those who are significantly affected by the complexity are those under age 30, over age 55, and the poor).

126. See *supra* Part I.B.

127. The combination of imprudent investment allocation and the elimination of the employer responsibility for the participant's investment decisions is likely to result in benefits which fall short of the expected retirement income replacement goal for some participants. See Donald Faller, *Give 401(k) Participants Customized Assistance*, Nat'l. Underwriter Life & Health Fin. Serv. Ed. 22 (May 15, 1995). See also *supra* Part II.C.1.

128. The Greenwich Associates studies indicate that 29% of companies with defined contribution plans are planning to comply with the safe harbor rules of § 404(c) in the near future. See *supra* Part II.C.3. The Department of Labor regulations on participant investments

Notwithstanding the shortcomings of participant directed plans, it would nevertheless be difficult, and perhaps counter productive, to eliminate them as retirement savings options, because of their tremendous appeal to employees and employers alike. In the absence of participant directed plans, some employers may choose not to establish plans, and some employees may choose not to participate. Even so, the self-help approach adopted by participant directed plans is inconsistent with ERISA's goal of increasing the retirement income security of plan participants. To provide the level of retirement income security envisioned by ERISA as originally drafted, there should be some residual fiduciary responsibility imposed on employers who sponsor participant directed plans. An education and notification requirement should also be imposed on sponsors of such plans. These changes would ensure that plan participants are qualified to make prudent investment decisions with regard to their retirement savings, and can appreciate the significance of the risk of shortages when they do not.<sup>129</sup>

#### *E. Residual Liability and a Notification and Education Requirement*

The private retirement system is employment based.<sup>130</sup> Therefore, it is only through employment relationships that such benefits are made available. One of the rationales for the employment based characteristic of the private pension program is that there are comparative advantages from saving in employer sponsored plans as opposed to personal savings arrangements.<sup>131</sup> First, saving for retirement requires financial investment expertise. Because it is more likely that the employer is in a better position to retain financial experts than the employees, participants typically receive greater returns inside a plan than outside.<sup>132</sup> Second, an employer who invests large amounts can benefit from economies of scale. As a result, investment returns should be higher, and administrative costs should be lower, inside an employer sponsored plan.<sup>133</sup>

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under § 404(c) of ERISA were issued in October 1992 and took effect January 1, 1994. See Most Firms Comply with Section 404(c) Rules, 21 Pens. & Ben. Rep. (BNA) 1100 (June 6, 1994).

129. See *supra* Part II.C.2.

130. See Langbein & Wolk, *supra* note 5, at 32.

131. See Munnell, *supra* note 11 at 54; see also Langbein & Wolk, *supra* note 5, at 32.

132. See Langbein & Wolk, *supra* note 5, at 32.

133. See Langbein & Wolk, *supra* note 5, at 32-33. Although not discussed in this article, wider participation is another reason the private pension system is employer based. In other words, another rationale for the tax favorable treatment of qualified plans is that retirement benefits for rank and file employees will exist only if Congress provides tax incentives that will induce higher paid employees to support the establishment of employer sponsored retirement savings plans. *Id.* at 200-03 (citing Bruce Wolk, Discrimination Rules for

Another characteristic of the private pension system is that it is voluntary. Employers are encouraged to establish qualified plans with substantial tax benefits.<sup>134</sup> The basic tax advantage is tax deferral. Amounts contributed to qualified plans by employers are not taxed to the employee when they are made. Also the earnings on the contributions accumulate tax-free, and the employee is not taxed on the amounts in the plan until they are distributed.<sup>135</sup> In connection with the favorable tax treatment of pension plans, the Treasury forgoes large amounts of tax revenue each year.<sup>136</sup>

Because the preferential tax treatment of retirement benefits reduces the employee's current taxable income, it is possible for the employer to deliver a dollar of retirement income at a lower cost than it could deliver a dollar of current wages to its employees.<sup>137</sup> Accordingly, an employer is able to reduce

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Qualified Retirement Plans: Good Intentions Confront Economic Reality, 70 Va. L. Rev. 419, 426-33) (1984).

134. "Qualified plans provide the most tax effective way of delivering retirement income, because (i) the employer receives a current tax deduction for contributions to a trust, (ii) the trust pays no tax on its investment income, and (iii) the employee pays no tax until he receives a distribution from the trust." Max J. Schwartz & Lora S. Collins, *Securing the Promise to Pay: Funding of Non-Qualified Deferred Compensation*, 328 PLI/Tax 275, 279 (July-August, 1992); see also Frank P. Vanderploeg, *Role-Playing Under ERISA: The Company as "Employer" and "Fiduciary,"* 9 DePaul Bus. L.J. 259, 272 n.43 (1997).

135. See Langbein & Wolk, *supra* note 5, at 156.

136. The cost to the Treasury in the form of forgone revenue. The annual cost of the private retirement program is an estimated \$64 billion. See EBRI Databook, *supra* note 19, at 19-23, tbl. 2-5. The tax expenditure estimates for pensions are calculated on a cash flow basis. This method of calculation has the effect of placing no value on the pension promise itself, only on the advanced funding of the promise. See EBRI, *Pension Tax Expenditures: Art They Worth the Cost?*, Feb. 1993, #134.

137. See IRC § 402(a)(1). An employee may be willing to accept a lesser-valued plan contribution in exchange for current compensation, e.g., a \$4,500 plan contribution in place of \$5,000 in current compensation, because the \$4,500 is tax free. See Mary Oppenheimer, *From Meldrum to Indopco: Should Qualified Plan Professional Fees Be Capitalized?*, 40 Wayne L. Rev. 109, 131-132 (1993) (citing Bruce Wolk, *Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality*, 70 Va. L. Rev. 419, 432 (1984)); Langbein & Wolk, *supra* note 5, at 149 (discussing the tax treatment of qualified plans). A related but different issue is the extent to which current wages are reduced in connection with expected retirement benefits, i.e., higher pensions lead to lower wages. While no one would deny that the retirement income contribution is a part of an employee's wage package, the extent to which workers wages are effected by their expected retirement incomes is difficult to determine. See Munnell, *supra* note 11, at 2. One view says the plan participants give up wages equal to the value of the benefits that they accrue each year. See Edward Thomas Veal & Edward R. Mackiewicz, *Pension Plan Terminations* 204 (1989). Another view is that of the "implicit contract" hypothesis. This view says that an employee's wages are reduced equal to the level payment needed to fund the pension that is expected to be received if the plan continues indefinitely and the participant has a normal working life time with the employer. For example, if an employee expects to be employed for 30 years, and the anticipated normal retirement benefit under the plan is \$300 per month, and the first year's amortization of this benefit would



current compensation by more than the actual amount of contributions made to the plan. Arguably, the economic benefits enjoyed by employers are justifiable only if participants are in fact better off being covered by an employer sponsored arrangement than they otherwise would be.

Although sponsors of participant directed and employer directed plans enjoy equal tax benefits, participants of the plans are not accorded the same nontax advantages. In participant directed plans, participants, not the employer, make the investment decisions. Thus, the participants do not benefit from the employer's investment programs, or financial guidance. Furthermore, any advantages derived from economies of scale are diminished, if the participants fail to make prudent investment decisions. Therefore, another reason to impose residual liability on sponsors of participant directed plans is to justify the economic benefits they receive, as well as to justify the overall cost of the retirement savings program.<sup>138</sup>

The education requirement should also mandate a variety of educational mediums. There is substantial evidence showing that printed communication generally is ineffective in aiding the investment education of plan participants because employees either do not understand written materials, or disregard them.<sup>139</sup> Thus, the requirement should specifically include a complement of written materials, seminars, and financial planning software on retirement asset management. Additionally, the education provided should be responsive to the investment needs of different groups of participants. For example, there should be age specific information.<sup>140</sup>

Finally, an education requirement should address the timing and frequency of retirement planning information. Presently, some employers offer one-time retirement planning sessions to older employees who are approaching retirement, but do not provide similar sessions for younger workers.<sup>141</sup> However, because the assets of younger workers are invested over longer periods of time, they are more likely to suffer from imprudent investment strategies than older

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be approximately \$270. Thus, the participant's current wages would be reduced by that amount to fund the expected retirement benefit. *Id.* at 204.

138. See Glenn E. Coven, *Corporate Tax Policy for the Twenty-First Century: Integration and Redeeming Social Value*, 50 *Wash. & Lee L. Rev.* 495, 512 (1993); see also Jefferson, *supra* note 93, at 253 (stating that all taxpayers pay the subsidy by paying "higher tax rates on the portions of their [retirement] incomes that do not enjoy special tax treatment").

139. See generally Ed Peratta, *401(k) Communication That Works*, *Pens. Mgmt.*, Dec. 1995, at 32; EBRI Releases Report on Participant Education for Improved Retirement Savings, 95 *Tax Notes Today* 86-51 (May 3, 1995).

140. Investment horizons will vary with age and will therefore affect investing strategies. Because of this, employer-provided information will need to address different issues with various groups. See Laurence B. Wohl, *Fiduciary Duties Under ERISA: A Tale of Multiple Loyalties*, 20 *U. Dayton L. Rev.* 43, 92 (1994); Keville, *supra* note 4, at 544.

141. See Keville, *supra* note 4, at 544.

employees.<sup>142</sup> Therefore, it would be important for the education requirement to require financial training for all workers throughout their working lives.

The education requirement would not only enable participants to make better investment decisions, but also would eliminate the catch twenty-two that employers currently face regarding investment advice and investment information.<sup>143</sup> The content, frequency, and medium of all communication regarding investment would be regulated. All participants would receive the same education. It would therefore no longer be necessary to use a cumbersome facts and circumstances analysis to classify communications between employers and employees as either advice or information. More importantly, however, plan participants would be better able to make prudent investment decisions and appreciate the future value of their expected retirement income in order to determine whether it is necessary for them to supplement their expected retirement benefits with increased personal savings.<sup>144</sup>

#### F. *Enforcement of a Notification and Education Requirement*

Under a properly implemented notification and education requirement, when an employer failed to comply, fiduciary liability for the resulting losses would be reinstated. Although determining the actual loss in a defined contribution plan is not a straightforward calculation, the loss could be determined using any one of several approaches. For example, the actual loss could be determined by the excess of either the average rate of return for Treasury Bills, or the average rate of return for a specified portfolio mix, over the actual rate of return earned by the account.<sup>145</sup>

After determining the loss, an excise tax should be imposed on the employer. The excise tax could be a flat rate excise tax designed to recoup an account holder's lost investment build-up. Alternatively, like the section 4971 tax for underfunding, the flat rate excise tax could be imposed at a rate high enough to both recoup asset losses, and discourage noncompliance. Another option is for the excise tax to be calculated on a case-by-case basis, using particular facts and circumstances to measure the loss, exactly.<sup>146</sup> Regardless of how the tax is determined or structured, however, under no circumstances should employers who completely insulate themselves from liability for imprudent investment

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142. *Id.* Poor returns compounded over the working life of a young employee result in greater gaps between expected and actual benefits than poor returns compounded only briefly as for older employees. *Id.*; cf. Fitzpatrick, *supra* note 9, at 79.

143. See *supra* notes 101-102 and accompanying text.

144. See Dallas Salisbury, *ERISA's Success and the Vista for the Future*, *Pens. & Inv.*, Aug. 22, 1994, at 14.

145. See discussion *infra* Part III.E.1.

146. See Jefferson, *supra* note 26, at 36.

decisions enjoy the same level of tax benefits as sponsors who retain liability when such losses occur.

### III. INSURANCE PROTECTION AGAINST MARKET FLUCTUATIONS

#### A. *The Gap In Insurance Protection*

The goal of ERISA was not only to protect participants from fiduciary misconduct and asset mismanagement, but also to protect plan participants from pension default.<sup>147</sup> Thus, in addition to establishing higher fiduciary standards for managers of employee benefits, as part of ERISA Congress also established a federal insurance program administered by the PBGC to protect participants from benefit loss due to plan failure.<sup>148</sup>

Under the pension insurance program the PBGC provides substantial protection of defined benefit plan accruals, but not of defined contribution plans.<sup>149</sup> Section 3(34) of ERISA specifically provides that PBGC protection is not available to individual account plans.<sup>150</sup> This section defines individual account plans as plans in which the level of benefit for each employee fluctuates depending on the experience of the account. Because the retirement benefit in defined contribution plans is dependent upon actual contributions made to an account and the investment performance of each separate account, all defined contribution plans are excluded from ERISA's insurance program.<sup>151</sup>

When ERISA was established in 1974, Congress could not have anticipated the recent shift from defined benefit plans to defined contribution plans.<sup>152</sup> Thus, the failure to provide insurance protection for defined contribution plans may have been appropriate when the number of defined contribution plans was not expected to rise. However, because thousands of plan participants now rely upon defined contribution plans as their primary retirement savings vehicles, the financial security of many future retirees will depend on how successful defined contribution plans are in accumulating, and delivering their expected retirement benefits. Therefore, notwithstanding the historical explanation for the absence of insurance protection for defined contribution plans, the gap in insurance protection is no longer appropriate or justifiable. Insuring a minimum investment return in retirement savings plans is not only a feasible idea, but what

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147. See Langbein & Wolk, *supra* note 5, at 92-93.

148. See McGill & Grubbs, *supra* note 54, at 55.

149. See Edward R. Mackiewicz, *Pension Plan Terminations: Procedures and Liabilities*, 444 PLI/Comm 51, 58 (1988); see also Keville, *supra* note 4, at 553.

150. See 29 U.S.C. § 1002(34) (1995) (defining a defined contribution plan as a plan providing an individual account for each participant).

151. ERISA, 29 U.S.C. § 1321(b).

152. See *supra* Part I.A.

actually occurs under the existing defined benefit plan insurance program in certain circumstances.

### B. *Reasons for Shortfalls*

Two of the most prevalent reasons for shortfalls in defined benefit plans are the failure of employers to contribute sufficient amounts for past service costs, and unfavorable investment returns.<sup>153</sup> The funding of ongoing defined benefit plans is determined by the use of actuarial cost methods. Actuarial cost methods estimate plan costs and assign the costs to appropriate years.<sup>154</sup> The present value of pension benefits and liabilities depends on the actuarial assumptions selected for interest, early retirement, turnover, and salary increases.<sup>155</sup>

The funding rules require a plan sponsor to contribute annually an amount equal to the current plan year cost. This amount is referred to as the "normal cost" of the plan.<sup>156</sup> The normal cost allocates future plan costs over the life of the plan and can vary significantly depending on the actuarial assumptions and the funding method used by the plan.

In addition to the plan's normal cost, the employer's annual contribution must cover amounts attributable to supplemental costs. Unlike the normal cost, the supplemental costs may not be funded at once, but rather must be amortized over specified periods of time.<sup>157</sup> Supplemental costs include amounts derived

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153. See Canan, *supra* note 30, at 605, 609.

154. Cost are assigned to appropriate years to prevent the employer's deduction from being too large, as well as to create a systematic funding schedule. See Jefferson, *supra* note 26, at 5; McGill & Grubbs, *supra* note 54, at 375; see IRC § 412. Any of several actuarial cost methods may be selected if the actuary certifies that the method and assumptions are reasonable in the aggregate. McGill & Grubbs, *supra* note 54, at 393-94. ERISA lists six acceptable actuarial cost methods, but it is possible that additional methods may be designated as acceptable by the Internal Revenue Service. *Id.* Any change in the method used may be made only with the prior approval of the Internal Revenue Service. *Id.*

155. See Jefferson, *supra* note 26, at 11 (citing Langbein & Wolk, *supra* note 5, at 228).

156. The normal cost will vary depending on the funding method selected. See Jefferson, *supra* note 26, at 5. If a plan's cost is determined on the basis of accrued benefits, the normal cost is the actuarial present value of the benefits accrued in a given year. *Id.* If the cost is based on projected benefits, the normal cost is generally the level percentage of pay necessary per year to fund the projected benefits for all years of service. *Id.*

157. See discussion *infra* Part IV.C.

from plan amendments, experience losses,<sup>158</sup> inaccurate actuarial assumptions, and past service credits.<sup>159</sup>

Liabilities for past service credits are the most common supplemental cost.<sup>160</sup> Past service liability occurs when an employer gives credit for service prior to the date on which the plan was established.<sup>161</sup> Thus, prospectively viewed the past service liability, also known as the accrued liability, is the amount that, together with future plan costs, is expected to cover all benefit costs incurred under the plan.<sup>162</sup>

The excess of the accrued liability over a plan's assets is the "unfunded past service liability."<sup>163</sup> When plans terminate before there is time to make sufficient contributions to cover the past service liability, there will be insufficient funding, unless errors in the accompanying actuarial assumptions are offsetting.<sup>164</sup>

Regardless of how carefully the actuarial assumptions are selected, advanced funding methods produce only cost estimates, not actual costs.<sup>165</sup> Thus, typically a plan will either have a funding surplus or a funding deficiency, since any deviation in the assumptions when compared with actual plan experience will produce a shortfall, or a windfall.<sup>166</sup>

When a defined benefit plan terminates with insufficient assets, the PBGC pays the plan's vested accrued benefits at the time of termination.<sup>167</sup>

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158. Experience losses occur when actual plan costs exceed the actuarial estimates for a given plan year. For example, if the actuary assumes that the plan investments will earn 8% and the investment earned only 5%, the plan will have a deficiency, or an actuarial loss. See generally Canan, *supra* note 30, at § 12.3, at 607-11; Langbein & Wolk, *supra* note 5, at 285.

159. Supplemental costs also include waived funding deficiencies, which occur when the Secretary of the Treasury, acting through the Internal Revenue Service, waives part or all of a plan's annual contribution upon a showing of substantial financial hardship such that making the plan contribution would adversely affect plan participants. See IRC § 412(d); see also Langbein & Wolk, *supra* note 5, at 290-91.

160. Past service liability can arise in two ways: (1) it may accrue for service rendered before the plan was adopted, or (2) it may apply to service rendered by an employee after adoption of the plan but prior to a plan amendment which provides increased coverage for such service. See Canan, *supra* note 30, at 593.

161. "The past service liability is also referred to as the 'accrued liability.' Despite its name, the accrued liability of a plan is not an accounting or legal liability." Jefferson, *supra* note 26, at 5 n.21.

162. *Id.*, at 5.

163. IRC § 412(b)(2)(B).

164. If, for example, there were substantially higher turnovers among nonvested participants, there may be sufficient forfeitures to offset an incorrect interest rate assumption. See Halperin, *supra* note 7, at 772-73.

165. See Jefferson, *supra* note 26, at 11.

166. *Id.*, at 12.

167. After five years of participation, the PBGC guarantees the participant's vested accrued benefits. In order to fund the cost of the benefits, the PBGC uses the assets held by the

Accordingly, the PBGC insures plan participants against shortfalls that arise from the differences in the estimated funding cost and the actual cost of a defined benefit plan.<sup>168</sup> Regardless of which actuarial assumption is inaccurate, all deficiencies are treated the same. If a plan experienced losses due to an erroneous turnover assumption and ultimately terminated, the PBGC would be liable for the unfunded vested accrued benefits. Similarly, if the deficiency were attributable to an erroneous interest rate assumption, the PBGC would also be liable.<sup>169</sup>

In reality, the latter situation is more likely to occur.<sup>170</sup> Because the interest rate assumption typically reflects the long-term nature of the pension obligations, a change in the interest rate assumption affects the valuation results more than a change in any other actuarial assumption.<sup>171</sup> Although the impact of an inaccurate interest rate assumption depends upon the number of years involved, the age distribution of plan participants, and the weighting of plan liabilities,<sup>172</sup> the rule of thumb to which actuaries generally adhere is that a ½% change in the interest rate results in a change in liabilities of approximately 6% in a valuation period.<sup>173</sup> Thus, accuracy of the interest rate assumption is especially critical in preventing shortfalls.

underfunded plan and then makes up the shortfall with its own funds. Daniel Keating, *Pension Insurance, Bankruptcy and Moral Hazard*, 1991 Wis. L. Rev. 65, 70 (1991).

168. The use of different funding methods could impact whether a plan has an actual funding deficiency or not. See Jefferson, *supra* note 26, at 31-32; see generally Norman P. Stein, *Reversions from Pension Plans: History, Policies, and Prospects*, 44 Tax L. Rev. 259, 265-67 (1989).

169. Provided the assumptions are reasonable.

170. See Jefferson, *supra* note 26, at 54.

171. *Id.*, at 54. A long term interest rate assumption is very difficult to project with certainty. The impact of the valuation interest rate on pension costs estimates depends upon the number of years involved in the interest discount, therefore, different parts of the evaluation are affected differently by a change in the valuation interest rate assumption. However, there is a rule of thumb to estimate the effect on liabilities of a change in the interests assumption. See *id.*, at 34 n.181 (citing Stuart G. Schoenly, *Pension Topics 10-11* (1991) (Society of Actuaries No. 460-24-91)).

172. The following comparisons illustrate the relationship between age and liability:

<u>Age</u>	<u>7% factor as a % of 6% factor</u>	<u>8% factor as a % of 7% factor</u>
25 Deferred Life Annuity commencing at age 65	64.2%	64.7%
45 Deferred Life Annuity commencing at age 65	77.5%	77.9%
65 Life Annuity	93.5%	93.8%

Schoenly, *supra* note 171, at 19.

173. *Id.* at 18.

Assuming all other assumptions are correct, when a plan experiences losses due to erroneous interest rate assumptions, a funding deficiency would result.<sup>174</sup> In such cases, if the plan terminated, and the employer were unable to make an additional contribution, the PBGC would pay the unfunded vested accrued benefits.<sup>175</sup> When the PBGC pays any portion of the retirement benefits in plans in which all actuarial assumptions other than the interest rate assumption are correct, the PBGC effectively insures a minimum investment return. Therefore, participants in defined benefit plans are insured against poor investment performance.

The PBGC's guarantee of a minimum investment return in defined benefit plans can be demonstrated best by a numerical illustration. Consider a defined benefit plan that assumes an 8% investment yield, uses an accurate mortality assumption and salary scale projection,<sup>176</sup> has made no past service award, and uses an accrual formula of 2% times average compensation times years of service. Assume Employee X is age 50, 100% vested, was hired at age 45, and received \$50,000 of compensation for each of the last five years. Employee X, therefore, currently has an accrued benefit of \$5,000 per year.<sup>177</sup>

Further assume that over the last five years, the plan has experienced losses attributable to an actual 7% investment return, as compared to the 8% return assumed by the plan. All other assumptions are accurate. Using the ½% to 6% rule of thumb, there would be a shortfall of approximately 12%. If the employer terminated the pension plan at this point, the shortfall in Employee X's retirement benefit would be provided by the PBGC.<sup>178</sup> In other words, the PBGC would guarantee a retirement benefit based upon an expected investment return of 8%. Interestingly, in a defined contribution plan there would be no insurance protection if the account balances of plan participants were less than expected as a result of unfavorable market conditions.

Oponents of federal insurance for defined contribution plans argue that losses in defined contribution plans resulting from market fluctuations are too difficult to measure.<sup>179</sup> Others argue that even if such losses are measurable, it is inappropriate for the federal government to insure them because Title IV of ERISA was established only to guarantee pension benefit promises, not minimum investment returns.<sup>180</sup> As illustrated above, however, although it appears that the

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174. This is true, unless there are offsetting errors in connection with the other accompanying assumptions.

175. See *supra* note 41 and accompanying text.

176. See Jefferson, *supra* note 26, at 11.

177.  $2\% \times \$50,000 \times 5 \text{ years} = \$5,000$

178. See *supra* Part I.A.

179. See Keville, *supra* note 4, at 554.

180. See Keville, *supra* note 4, at 554 (stating that defined contribution plan insurance might encourage "speculative investing by employees who are not risk averse, and could

existing insurance program for underfunded terminated defined benefit plans insures something other than a minimum investment returns on the plan assets, this is exactly what occurs in certain instances. In fact, one of the most significant risks against which a terminated defined benefit plan is protected is market fluctuation.<sup>181</sup> Therefore, objections to insuring investment returns in defined contribution plans on the grounds that it is inconsistent with the underlying policy of ERISA's Title IV insurance are invalid. Furthermore, resistance to defined contribution insurance because the insurable risks in defined benefit and defined contribution plans are different is also unfounded.

### C. Insurance Protection Outside of ERISA

Although there is no PBGC protection for defined contribution plans under ERISA, participants investing in certain relatively safe low-risk, low-yield instruments are nevertheless eligible for other insurance protection against market down-turn.<sup>182</sup> Stable-value investment contracts marketed by the banking industry are insured by the Federal Deposit Insurance Corporation (FDIC). Similar instruments marketed by insurance companies are covered by state-regulated insurance.<sup>183</sup> Thus, defined contribution plan participants investing in relatively safe, low-yield investments are covered by some type of governmental insurance.<sup>184</sup>

1. *Guaranteed Investment Contracts*.—Historically, insurance companies and banking institutions only provided investment management services. In more recent years, however, both industries have expanded their roles to include offering stable-value investment contracts, in addition to providing managerial expertise.<sup>185</sup> The Guaranteed Investment Contract (GIC) is the stable

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result in multiple payouts if employees repeatedly lost principle”).

181. See Sean S. Hogle, *The Employee as Investor: The Case for Universal Application of the Federal Securities Laws to Employee Stock Ownership Plans*, 34 *Wm. & Mary L. Rev.* 189, 240 n.96 (1992).

182. See discussion *supra* Part III.A, *infra* Part III.F, G.

183. See FDIC, *Facts About Bank Investments* (last modified Jul. 27, 1999) <<http://www.fdic.gov/deposit/investments/facts/index.html>>.

184. As a result, some defined benefit plan participants have two levels of insurance protection.

185. Pension assets are generally managed by a plan trustee. A trustee can be either an employee of the plan sponsor, a bank, a trust company, or an insurance company. When the assets are trusted by an employee, bank, or trust company, the employer makes annual contributions directly to the plan. When the funds are trusted by an insurance company, the employer pays the insurance company annual premiums in exchange for the insurance company's promise to pay future plan benefits as they become due. See *Employee Benefit Research Institute Issue Briefs* 15 (June 1994). See also Part II.C.



value instrument offered by insurance companies.<sup>186</sup> They have flourished since their inception in the early 1970's.<sup>187</sup> The success of GICs is attributed to the perception that they are extremely safe investments.<sup>188</sup> While the term "guarantee" may imply that the insurer provides "fail safe" protection for the return of the principal, the guarantee actually only applies to the interest rate and expense schedule.<sup>189</sup> Thus, the safety of the entire instrument depends on the solvency and credit worthiness of the issuing insurance company.<sup>190</sup>

Although interest rates paid to GICs have declined from their peak in the late 1980's, GICs nevertheless have remained very popular.<sup>191</sup> GICs are regulated under state insurance laws which vary from jurisdiction to jurisdiction. Therefore, the level of protection and payment criteria vary.<sup>192</sup> For example,

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186. The term GIC is most often defined as a Guaranteed Investment Contract; however, GIC sometimes is referred to as a Guaranteed Income Contract, Guaranteed Interest Contract, or Guaranteed Insurance Contract. All of these terms convey the same meaning which is a "fail safe guarantee of principal and a predetermined rate of interest to be credited over the investment's life." Kenneth L. Walker, *What is a GIC?, in Guaranteed Investment Contracts: Risk Analysis and Portfolio Strategies 21* (Kenneth L. Walker ed., 1992).

187. William H. Smith, *A Plan Sponsor's Perspective, in Guaranteed Investment Contracts: Risk Analysis and Portfolio Strategies 1* (Kenneth L. Walker ed., 1992). Today's GICs have an outstanding balance of approximately \$200 billion and are issued at the rate of approximately \$40 billion annually. *Id.*

188. Keville, *supra* note 4, at 543-44. Additionally, the nonvolatility of GICs enable the employer to avoid having to report negative returns in the annual financial statements given to plan participants. Defined benefit plans generally have not purchased investment contracts because of their low yield.

189. Walker, *supra* note 186, at 22.

190. GIC owners are considered the policyholder of the insurer. In most jurisdictions, the policyholder enjoys a senior lien over the general creditors of the insurer. Thus, in the event of bankruptcy, the policy holder would generally rank ahead of the general creditors of the insurance company. Walker, *supra* note 186, at 22. See also Smith, *supra* note 187, at 1.

191. See Frederick C. Kneip, *Synthetic BICs and GICs*, 381 *PLI/Tax* 273, 275 (1996). Approximately 70% of all 401(k) assets are committed to GICs or other similar stable valued options. See generally Walker, *supra* note 186, at 32.

192. Many amounts deposited by plans with an insurer are allocated to a separate account. These separate accounts are generally deemed by state insurance laws to be the property of the insurer. Robert E. Rice, *Synthetic BICs & GICs*, 339 *PLI/PAT* 321, 330-31 (1993). Consequently, if the insurer initiates insolvency or rehabilitation proceedings, the plan's account may be frozen indefinitely, which could affect benefit liquidity or the interest rate earned on the GIC. *Id.* It has been suggested that to avoid this, physical custody of the assets could be placed in a third party. This would allow the plan uninterrupted access, and would also make the insurer a fiduciary of the plan. *Id.* In addition, annuitants may have a claim in the state liquidation proceedings. James Epstein, *Protecting Pension Annuities When Insurance Companies Fail: The ERISA Fiduciary Standards*, 44 *Fla. L. Rev.* 107, 110 (1992); see also Peter A. Fine, *What to do if Your Insurer is Insolvent*, 439 *PLI/COMM* 139 (1987). Also, insurance industry practice has been to protect annuitants hurt by the collapse of an annuities company through the state insurance regulations. *Retirees at Risk: The Executive Life Bankruptcy: Hearing Before the Subcomm. on Labor of the Sen. Comm. on Labor and Human Resources*, 102

under certain state insurance laws, GICs are protected against insolvency by life insurance guaranty funds which typically limit the amount payable per claim.<sup>193</sup>

2. *Banking Investment Contracts.*—The Bank Investment Contract (BIC) is another type of stable-value instrument.<sup>194</sup> BICs are offered by banks rather than by insurance companies.<sup>195</sup> BICs are insured by the FDIC, up to \$100,000, per deposit, per account.<sup>196</sup>

Until recently, when an employer sponsored a retirement plan invested in BICs, a \$100,000 cap applied to the plan as a whole. The cap did not pass through to individual participants. However, in 1991 Congress passed the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA),

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Cong. 23 (1991) (statement of David George Ball, Asst. Secretary, Pension and Welfare Benefits Administration, U.S. Dept. of Labor).

193. However, any attempt to access a guaranty fund to satisfy GIC claims against a large insolvent insurer would raise the following issue:

most such funds are not “pre-funded”; instead, an assessment is made by the fund against the remaining solvent insurance companies doing business in the state only after the need to honor claims has arisen. If the claims presented to the guaranty fund were very large, it might not be possible to make sufficient assessments without jeopardizing the financial health of the remaining insurance companies.

Rice, *supra* note 192, at 331. It is uncertain whether a GIC purchased by a retirement plan would constitute a single claim, or whether the per-claim provisions would “pass through,” and apply to each beneficiary of the plan. Whether the claim is viewed as a single claim or not determines the applicable level of insurance protection under state law. *Id.*

194. The legal form of the BICs differs from bank to bank. Banks generally issue BICs either in the form of time deposits or money market deposit accounts. The Board of Governors of the Federal Reserve, which regulates the banking industry, provides definitions for each form of deposit accounts in its regulations. David J. Salvin, *Bank Investment Contracts*, in *Guaranteed Investment Contracts: Risk Analysis and Portfolio Strategies* 37 (Kenneth L. Walker ed., 1992).

195. Although BICs are similar to GICs in many respects, the industry distinctions between banking and insurance account for differences such as credit-worthiness, plan language, government reporting, pricing, and most importantly, the availability of FDIC insurance. Walker, *supra* note 186, at 38. The relative success of BICs stems from the desire for industry diversification. Prior to the introduction of BICs, a plan wishing to offer a stable value option was limited to GICs and money market funds. Sponsors were dependent upon the solvency of the insurance industry. *Id.* at 38-39. BICs allowed employers to spread their investments over two industries. However, simultaneously with the rise in BIC popularity, many large banks saw their credit ratings drop, and experienced downgrades and negative press. The insurance industry, being the familiar option, did not experience similar consequences. *Id.* at 39.

196. Both the principal and the interest of a BIC account are federally insured in domestic member banks. A domestic member bank is “a depository institution that is a member of the Federal Reserve.” Michael Gordon Hales, *The Language of Banking* 114 (1994). National banks are required to be members; state-chartered commercial banks and mutual savings banks may become members at their election. *Id.* Member banks are owners of stock in Federal Reserve Banks and choose some of the Reserve Bank directors. *Id.*

which established pass-through insurance for certain banks that brokered deposits to retirement plans.<sup>197</sup> As a result, FDIC insurance currently applies to individual plan participants as if they were individual depositors.<sup>198</sup>

3. *Retirement Certificates of Deposit (CDs).*—Retirement Certificates of Deposit (CDs) are a personal savings alternative available to taxpayers outside of the employer-sponsored regime.<sup>199</sup> A retirement CD is an insurance contract that is invested in CDs. This arrangement offers tax deferral until retirement on the investment returns, and provides guaranteed interest rates for

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197. Under provisions set forth by the Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991, deposits of trusts may not be insured on a pass-through basis "(A) if the trustee or an organizer of the trust solicits persons to transfer funds into the trust; (B) if interests in the trust are sold to beneficiaries; (C) if there are more than 10 settlors or grantors of the trust; or (D) in such other circumstances as the Board of Directors may prescribe." 137 Cong. Rec. S17910, S17923 (daily ed. Nov. 23, 1991). Additionally, banks must meet the requirements of IRC §§ 401(a) and 403(b)(9). Pass-through FDIC insurance protection generated considerable controversy. The American Council of Life Insurance (ACLI) sought the repeal of pass-through insurance legislation. The ACLI was established in 1976 after a merger of several existing organizations. It currently represents 532 U.S. legal reserve life insurance companies, providing industry reports, consumer brochures on insurance, and unified lobbying efforts for life insurers at state and federal levels. See Nina Easton, *Financial Industry Lobbyists Come from Different Perspectives*, *American Banker*, Oct. 19, 1985, at 11; see also American Council of Life Insurance, <http://www.acli.com> (as of March 1998). See *Investments: Federal Deposit Insurance Unnecessary Due to Existing Protections*, *Official Says*, 18 *Pens. Rep. (BNA)* 781 (May 6, 1991) (maintaining that this result is dangerous as it tempts poorly capitalized banks to offer very high yields in order to attract deposits, thereby increasing the likelihood of bank failure).

198. In 1994, the Federal Deposit Insurance Corporation finalized regulations to incorporate the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) relating to deposits for employee benefit plans accepted on a "pass-through" basis. Alson R. Martin, *Recent Developments Affecting PCs and Other Closely Held Businesses*, 884 *A.L.I.-A.B.A.* 1, 34 (Feb. 10, 1994). The regulations explicitly provide that the \$100,000 limitation applies to the aggregate interests of an employee's deposits with the insured institution under all plans established by the same employer, or by the same employee organization. See *id.* at 35. For purposes of the \$100,000 limitation, IRA's and participant directed individual account plans established by the individual investor are aggregated with employer sponsored amounts. See *id.* at 35.

199. A Retirement CD is a special type of BIC. It is therefore accurate to refer to Retirement CDs as BICs. Most BICs are issued as fixed-rate instruments, typically issued as nonnegotiable, benefit responsive arrangements. They sometimes contain a window provision, and often have early-withdrawal provisions that allow withdrawals to be made before maturity for reasons other than benefit payments after the imposition of a market adjustment. When the benefit-responsiveness and window features are removed, what remains is a fixed-rate, nonnegotiable instrument that contains an early-withdrawal penalty. This instrument is known as a time deposit or nonnegotiable certificate of deposit, or a Retirement CD. See McGill & Grubbs, *supra* note 54, at 475-78.

periods up to five years, on amounts payable as annuities.<sup>200</sup> The Retirement CD is a savings option which is particularly attractive to individuals close to retirement who are looking for safe places to store their personal savings.<sup>201</sup>

Currently, rates for Retirement CDs are better than national CD averages; however, because funds cannot be transferred to other banks without paying taxes and penalties, it is expected that banks will establish rates below market levels during subsequent 5 year periods.<sup>202</sup> Presumably, heightened consumer interest in Retirement CDs is largely attributable to the fact that these savings arrangements are insured by the FDIC up to \$100,000, per account, per individual.

#### D. *Defined Contribution Plan Insurance*

FDIC insurance encourages investment in BICs and retirement CDs over other noninsured forms of investment. However, an investment strategy that disproportionately selects low-risk, low-yield instruments such as BICs, and retirement CDs, contravenes the modern portfolio theory of investment which emphasizes diversification as a means of maximizing investment returns.<sup>203</sup> Therefore, the use of conservative investment strategy is not appropriate for long term investment goals, such as retirement savings.

The fact that participants tend to under-diversify their investment portfolios by disproportionately investing in stable-value instruments suggests there is a need for Congress to enact laws which encourage participants to invest their retirement savings more aggressively, rather than more conservatively.<sup>204</sup> A properly designed federal insurance program for defined contribution plans could achieve this goal. A defined contribution insurance program which guaranteed an average rate of return over a participant's working life would encourage participants to invest more aggressively because a portion of the risk of loss would shift from the participant to the insurer.<sup>205</sup> This approach is consistent with ERISA's goal of increased retirement security, because a

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200. These arrangements also rely on the favorable treatment of annuity contracts under IRC § 1275(a)(1)(B)(i). See Stephen D. Palmer, Comment, What do you Get When you Cross a Certificate of Deposit with an Annuity?: The Retirement Certificate of Deposit Struggles for Survival, 45 Emory L.J. 1429, 1432 (1996).

201. The high demand for Retirement CDs suggests that many savers are willing to forgo higher returns and immediate penalty-free access to their funds in exchange for federal insurance. See *id.* at 1459.

202. See Duff McDonald, Retirement CDs Offer More Than 7% - Plus Headaches, *Money*, May 1, 1995, at 57.

203. See *supra* Part II.C.1.

204. See *supra* Part II.C.2.

205. See discussion *infra* Part III.E.1.

balanced investment portfolio increases retirement security by maximizing long-term returns.<sup>206</sup>

Federal insurance for defined contribution plans also would eliminate the uncertainties and inconsistencies that result from the gap in insurance protection for defined contribution plans. Under existing law, plan participants receive vastly different levels of insurance protection of their retirement benefits depending on the classification of their retirement plan, the type of investments selected, and the states in which they reside.<sup>207</sup> Federal insurance for defined contribution plans would eliminate these inequities by conferring upon all qualified plan participants some level of insurance protection.

Defined contribution plan insurance is a highly controversial concept. Resistance to the idea includes both theoretical and practical concerns. There are, for example, concerns about identifying the goals and objectives of the program. There is also concern about defining an insurable accrued benefit in the context of individual account plans. Furthermore, issues regarding the appropriate insurance levels and applicable limitations would have to be resolved before a defined contribution plan insurance scheme could be adopted.

While all of these concerns are valid and should be addressed prior to the establishment of a defined contribution plan insurance program, they are not unique to such a program. When the existing defined benefit plan insurance program was established, policymakers found it necessary to address many of the

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206. The most conservative investments are not necessarily the most prudent ones since “‘an investment can ordinarily be made which will yield a higher income and as to which there is no reason to anticipate a loss of principal.’” Weiss & Sgaraglio, *supra* note 56, at 1185 n.23 (quoting Restatement (Second) of Trusts § 227(a)).

207. The Executive Life crisis of 1988 best illustrates the magnitude of the threat imposed by the gap in insurance. The Executive Life Insurance Company invested heavily in junk bonds. When the market crashed in the late 1980's, Executive Life was unable to pay its contracts and ultimately filed bankruptcy. While all plan participants whose assets were invested in Executive Life were affected by the company's collapse, the damages were more devastating for some participants than for others. Employee-participants in defined benefit plans were accorded PBGC protection while those in defined contribution plans were not. Because payments of defined contribution retirement benefits varied under state laws, some retirees received as much as 70% of their retirement benefits, while others received none. Had investors selected BICs instead of GICs, the participants would have been insured up to \$100,000 per account. From a pension policy perspective, it is difficult to justify this result. Until the conservatorship of Executive Life, there had never been an instance when an insurance carrier had not been able to honor its investment contracts. Therefore, the Executive Life crisis can be viewed as a milestone in pension history. Policymakers should be aware of the level of devastation that defined contribution plans can experience when retirement funds disappear. Moreover, the Executive Life crisis should serve as a reminder that as long as the gap in federal insurance protection exists for defined contribution plans, the promise of ERISA will not be fulfilled for some plan participants. See Gary M. Ford, *Defined Contribution Plan GIC Litigation, Annuities Legislation, and PBGC Legislation*, C996 A.L.I.-A.B.A. 183, 187 (1995).

same issues, including the appropriate levels of benefits to insure, and the necessary limitations to impose.<sup>208</sup> The pre-ERISA Committee placed limits on the maximum insurable amount in defined benefit plans because it believed it inappropriate to guarantee amounts in excess of a basic retirement benefit.<sup>209</sup> The structure of these limits remains in effect today. Thus, there are many lessons that can be learned from the existing defined benefit plan insurance program in connection with the implementation of a new insurance program for defined contribution plans.

#### *E. The Hypothetical Account Proposal—An Insurance Model*

The defined contribution insurance model proposed in this section is a risk-based, voluntary program that uses a diversified hypothetical account to determine the level of insured benefit. This proposal provides insurance protection for defined contribution plans comparable in amount and objective to the insurance protection currently available for defined benefit plans. Using this approach, participants of defined contribution plans would be insured against the risk of earning less than average investment returns, over their working lives.

Under the Hypothetical Account Defined Contribution Plan Insurance Program, to the extent that a participant's account complied with a prescribed diversification standard, she would receive a minimum benefit at retirement. The minimum retirement benefits would be based on hypothetical annual rates of investment returns, and would be payable when the insured participant reached her social security retirement age.<sup>210</sup> Insured amounts would be payable in the form of a life annuity, rather than a lump sum, in order to spread the risk of payment over longer periods of time.<sup>211</sup>

Annual guaranteed rates of investment return would be determined by the performance of a hypothetical account assumed to be invested according to

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208. See Ford, *supra* note 207, at 186-87.

209. This figure has been amended since the establishment of ERISA in 1974. Initially, defined benefit plans were insured up to the vested accrued benefit, not to exceed \$750 per month and not more than 50% of wages. The current insurable benefit in a defined benefit plan is the lesser of \$30,000 per year, or 100% of compensation. 29 C.F.R. § 4022.22; see *supra* note 12 and accompanying text.

210. "The Social Security retirement age is currently 65, but it will eventually increase to 66 for those born after 1938 and 67 for those born after 1954." Langbein & Wolk, *supra* note 5, at 268. Distributions prior to a participant's social security retirement age would be permitted in the event of death or disability.

211. In order to avoid a possibility of initial payments being made based on a number of years less than 5, under a defined contribution plan insurance program, only participants age 60 and below should be eligible to initially participate. This was a problem under the current pension insurance program. As a result, when it was first established the PBGC had to pay large sums that were attributed to years prior to the establishment of the insurance program.

a prescribed diversification formula. For a given year, the guaranteed annual rate of return would be the average of the annual hypothetical investment returns for the five prior years. A five-year average is used instead of the performance of a single year to diffuse the impact of sudden market fluctuations, and further spread the risk of payment. The use of a five-year average to determine the annual guaranteed minimum rate of return would also protect participants against sudden downturns in the investment market.<sup>212</sup>

Insurance protection would be determined by the extent to which an account complied with a prescribed allocation formula. In connection with the prescribed allocation formula, it would be necessary to develop an indexing system to evaluate all investment funds, so that the level of risk of a participant's investment allocation could be compared to the risk of the prescribed allocation.<sup>213</sup> A ratings system similar to that supplied by the various rating services, such as Standard and Poors, could be utilized to facilitate the indexing process.<sup>214</sup> Alternatively, a totally independent rating system could be developed based on the historical investment performances, and long-term accumulation projections for retirement plan assets<sup>215</sup>.

The Hypothetical Account proposal allows sponsoring employers and plan participants to insure some, or all, of an account balance, in exchange for the payment of an annual insurance premium. Although the annual premium would be paid separately from the individual accounts, the payment of an annual premium would obviously impact a participant's investment position, by decreasing the assets that remained available for her to contribute to the plan. Even after taking the premium payment into account, however, in most circumstances insurance protection under this proposal should provide a return on aggregate employer contributions of an amount at least as great as the return on an account exclusively invested in low-risk, low-yield instruments, such as BICs.<sup>216</sup> Thus, insurance protection under the Hypothetical Account insurance

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212. However, if unfavorable market conditions existed over a sustained period of time, the guaranteed rate of return would eventually reflect such losses.

213. For this purpose the Standard and Poors rating system could be used, or alternatively, a new rating system could be developed.

214. "A Standard & Poor's insurance claims-paying ability rating is an opinion of an operating insurance company's financial capacity to meet the obligations of its insurance policies in accordance with their terms." Claims paying ability ratings are divided into two broad classifications. Rating categories from AAA to BBB are classified as "secure" claims-paying ability ratings and are used to indicate insurers whose financial capacity to meet policyholder obligations is viewed on balance as sound. Rating categories. Allan G. Richmond, *Quality-Analyzing the Life Insurance Industry*, in *Guaranteed Investment Contracts: Risk Analysis & Portfolio Strategies* 100 (Kenneth L. Walker ed., 1992).

215. The investment practices for pensions typically reflect longer term investments.

216. If the insured rate is only slightly greater than the BIC return insuring, the account balance generally would still be advantageous. However, it is plausible that the insured

model should encourage risk averse individuals who are more likely to disproportionately invest in stable-value instruments, to invest more aggressively.

Unlike the existing mandatory insurance program for defined benefit plans, the Hypothetical Account insurance program would be voluntary. The voluntary characteristic of the proposal strikes a balance between individual choice and retirement income security. However, because of the voluntary characteristic of the program, it is unlikely that all defined contribution accounts would be covered.

The Hypothetical Account insurance model hinges on a diversification formula, which defines an acceptable range of complementary allocations with respect to both investment categories, and risk classifications. The diversification formula would be designed to approximate an average rate of return for accounts invested in average risk investment instruments over a participant's working life.<sup>217</sup> For example, the safe harbor diversification allocation could be selected consistently with the recommendations of financial planning experts<sup>218</sup> who advise individuals to place 60% of their investment assets in the stock of companies with moderate volatility,<sup>219</sup> 25% in "investment-grade" bonds,<sup>220</sup> and 15% in stable-value instruments, for a moderate return.

The level of insurance protection and the cost of the insurance premium would depend on the degree to which the participant's allocation complied with the diversification formula. Using the established indexing system, a risk factor

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rate would be substantially higher than that of the BIC because the safe harbor standard would require some portion of the account to be put in stocks and some portion to be put in bonds, which have rates that are generally higher than BIC returns. These instruments are currently FDIC insured. See discussion *supra* Part III.C.

217. The diversification formula would have to take into account the different recommendations for different age groups. Therefore the prescribed diversification formula would account for the more aggressive investment strategies that are recommended at the front end of one's working life as well as the more conservative strategy that is recommended at the back end of one's working life. See Weiss & Sgaraglino, *supra* note 56, at 1206-08.

218. See Strong Funds, Retirement Planning: Five Model Investment Strategies (visited Feb. 6, 2000) <<http://www.strong-funds.com/strong/Retirment98/ind/products/Spies.htm>>.

219. Beta is a measure of a stock's risk in relation to the market. For example, if the market is up 10% over the last year, and a particular company's stock price is also up 10% then the stock would have a beta of 1.0. The same principle applies when the market is down as when the market is up. <[www.duke.edu/~7echarvey/Classes/wpg/bfglosb.htm](http://www.duke.edu/~7echarvey/Classes/wpg/bfglosb.htm)>. See Campbell R. Harvey, Hypertextual Finance Glossary (visited Feb. 6, 2000).

220. Most corporate or municipal bonds are graded by Standard & Poor's Corporation, by Moody's Investors Service, Inc., or both. The issuers must pay these agencies a fee to review and to rate their bonds. Bonds are rated from the highest quality to the lowest on either the Standard & Pooers scale AAA/AA/A/BBB/BB/B/CCC/CC/C/D, or the Moody's scale Aaaa/Aa/A/Baa/Ba/B/Caa/Ca/C/. Any bond rated in the top four categories is considered an "investment grade" bond. See <<http://www.strong-funds.com/strong/LearningCenter98/concepts/glossary.htm#B>>.



would be assigned to all allocations in order to compare their risk exposure to that of the prescribed diversification standard. In order for an account to be fully insurable at the regular premium rate, the participant's account could not be exposed to an investment risk greater than that of the prescribed diversification formula. Accounts having a risk factor greater than that of the prescribed diversification formula would not be in compliance with the diversification standard, and accordingly, not insurable at the regular premium rate.

A very simple model of a diversification standard exists under current law for mutual funds. To qualify as adequately diversified, no more than five percent of a mutual fund's assets may be invested in the securities of any one issuer.<sup>221</sup> The Hypothetical Insurance Model proposed in this section adopts a similar approach. In order for an account to be insurable at the regular premium rate, the Hypothetical Account proposal requires that the investment exposure of a participant's portfolio be limited to the investment risk of the prescribed diversification standard.

1. *Calculation of the Guaranteed Benefit.*—Under the Hypothetical Account proposal, an individual's insurable principal would equal their annual employer contributions times the annual guaranteed rates of return, for each year of employment.<sup>222</sup> Each year's guaranteed rate of investment return would be based on the annual performance of a hypothetical portfolio, assumed to be in compliance with the prescribed diversification formula. The annual performance of the hypothetical account would be determined by the weighted average of the annual investment returns for a hypothetical portfolio using the prescribed diversification formula. The annual guaranteed rate of return for a given year would equal the average of the annual rates of investment return for the hypothetical account, over the five prior years.

An insured participant's minimum retirement benefit would be determined by comparing her actual account balance at retirement age to the Hypothetical Account balance determined by the annual guaranteed rates of return for each year of employment, prior to retirement.<sup>223</sup> If the participant's actual account balance fell short of the hypothetical account balance determined by the annual guaranteed rates of return, the difference would be paid by the insurer.

The Hypothetical Account insurance model is designed to protect the participant against the negative effects of severe market contractions over the

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221. See Weiss & Sgaraglino, *supra* note 56, at 1208; citing former 15 U.S.C. § 80a-5(b)(1) (1994).

222. The covered amount includes the elective contributions made by plan participants.

223. However, the minimum guaranteed amount applies only to the extent that the account had been invested according to the prescribed diversification standard.

participant's working life. Thus, if the market took a sudden downturn immediately preceding a participant's retirement, the participant would be guaranteed at least an average return on her aggregate contributions over her working life, notwithstanding her actual account balance at retirement.

Under the Hypothetical Account model, to avoid sudden fluctuations in payment claims, insurance protection would not be available for early distributions. Any distribution made from an account before a participant died, became disabled, or attained social security retirement age would constitute an early distribution.<sup>224</sup> Even if the plan provided for such distributions prior to normal retirement, such as for hardship, insurance protection would be unavailable. At an insured participant's death, the insured benefit would be calculated using the nonparticipant spouses's retirement age.<sup>225</sup> Under current law, similar treatment is given in connection with Qualified Preretirement Survivor Annuities (QPSAs) which provide survivor benefits to non-participant spouses in the event that a participant dies before reaching retirement age.<sup>226</sup> Insurance protection also would be unavailable for contributions made after retirement age. If an individual worked beyond retirement age, the insured retirement benefit would be unaffected by post retirement contributions or post retirement market conditions.<sup>227</sup>

The following example numerically illustrates the proposed Hypothetical Account insurance model. Assume that Employee X participates in a profit sharing plan which annually contributes 10% of compensation. Also, assume that Employee X had compensation of \$100,000 throughout her employment, began participating in the plan in 1986, and reached social security retirement age in 1995. Additionally, assume that the prescribed diversification formula was to allocate 60% to stocks, 25% to bonds, and 15% to stable-value instruments.<sup>228</sup> Further assume that Employee X's entire account was insured at all times.<sup>229</sup>

The annual rates of returns for 1981-1995 are illustrated in column 5 of Table I.<sup>230</sup> As described earlier, these numbers are assumed to be the composite

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224. This approach is generally consistent with current pension law. "Under § 72(t), a 10-percent additional tax is generally imposed on the taxable portion of any distribution made before the employee attains age 59 1/2, other than distributions made after the employee's death or by reason of disability. See Langbein & Wolk, *supra* note 5, at 349.

225. If the spouse were substantially older, there would be a sudden fluctuation.

226. The Retirement Equity Act (REAct) of 1984 mandates that plans recognize the surviving non-employee spouse as a plan beneficiary. This benefit is referred to as a Qualified Preretirement Survivor Annuity (QPSA). See Langbein and Wolk, *supra* note 5, at 555-56.

227. Because the insured benefit would be payable as an annuity, there could be some adjustment to the benefit for the delay in the annuity starting date.

228. See *supra* notes 218-20 and accompanying text.

229. In other words, the account was in compliance each year with the prescribed diversification standard.

230. The selected rates are assumed to reflect a composite of 60% moderately volatile

annual investment returns of a hypothetical portfolio, assumed to be in compliance with the diversification standard.<sup>231</sup> Column 6 of Table I illustrates the annual guaranteed rate of return, based upon an average of the hypothetical annual investment returns for the five prior years.

The actual composite rates of return for 1986-1995 are listed in column 2 of Table II. These numbers have been selected randomly to represent the average actual rate of return for funds in a particular account, invested according to the prescribed diversification formula.<sup>232</sup>

The annual contributions made to the employee's account for years 1986 through 1995 are listed in column 2 of Table III. The actual account balances for the corresponding years are listed in columns (3)-(12) of Table III.

The annual Hypothetical Account balances as determined by the annual guaranteed hypothetical return for years 1986-1995. These numbers are listed in columns (3)-(12) of Table IV.<sup>233</sup>

Table V shows the benefit Employee X was entitled to receive at retirement in 1996. The guaranteed minimum retirement benefit is the greater of columns 1 and 2 in Table V, in the participant's retirement year. If Employee X had died or become disabled prior to her retirement date, the guaranteed benefit would have been the greater of column 1 and 2 in the year in which the participant's death or disability occurred.

When the participant reached age 65 in 1995, the actual account balance was \$190,325, and the hypothetical account balance was \$203,824. Because the insured account balance exceeds the actual account balance, the participant would be entitled to receive the difference from the insurer. Employee X, therefore, would receive \$203,824 at retirement, rather than \$190,325, payable in the form of an annuity. While \$190,325 would be paid from the participant's individual account, the additional \$13,499 would be paid by insurance. The insured's benefit in this example represents an increase of more than 7% in the participant's retirement benefit.

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stock, 35% investment grade bonds, and 15% stable-value instruments. For purposes of this illustration, the numbers in columns 2, 3, and 4, of Table I have been randomly selected.

231. The separate rates of return for stock, bonds, and stable-valued funds for 1981-1995 are illustrated in columns 2, 3, and 4 of Table I, respectively.

232. The annual average hypothetical rate of return is a weighted average of 60% stock, 35% bond, and 15% stable-value funds.

233. These numbers are derived by multiplying the insured interest rate (Table II, column 2) by the actual contribution (Table III, column 2).

Table I

(1)	(2)	(3)	(4)	(5)	(6)
Year	Annual Hypothetical Rate of Return for Stocks	Annual Hypothetical Rate of Return for Bonds	Annual Hypothetical Rate of Return for Stable Value Funds	Annual Average Hypothetical Rate of Return <sup>*</sup>	Annual Guaranteed Rate of Return <sup>**</sup>
1981	14%	10%	6%	11.8%	—
1982	15	11	7	12.9	—
1983	16	12	8	13.8	—
1984	17	13	9	14.9	—
1985	16	12	8	13.8	—
1986	15	11	7	12.9	13.4%
1987	12	10	6	10.6	13.7
1988	13	11	7	11.7	13.2
1989	14	12	8	12.6	12.8
1990	15	11	7	12.9	12.3
1991	16	10	6	13.0	12.1
1992	17	9	5	13.3	12.2
1993	16	8	4	12.2	12.7
1994	15	7	5	11.6	12.8
1995	14	8	6	11.3	12.6

\*Weighted average of 60% stock, 35% bonds, and 15% stable value funds.

\*\* Average of five prior years.

Table II

(1)	(2)
Year	Actual Rates of Return <sup>*</sup>
1986	15%
1987	14
1988	14
1989	13
1990	13
1991	12
1992	12
1993	10
1994	10
1995	9

\* These numbers are selected randomly to represent the weighted average of actual returns for an account invested according to the prescribed diversification formula.

**Table III**  
**Actual Annual Account Balances\***

Composite rate of return from Table II.

(1) Contribution Date	(2) Contribution Amount	(3) 1/1/87 balance @ 15%	(4) 1/1/88 balance @ 14%	(5) 1/1/89 balance @ 14%	(6) 1/1/90 balance @ 13%	(7) 1/1/91 balance @ 13%	(8) 1/1/92 balance @ 12%	(9) 1/1/93 balance @ 12%	(10) 1/1/94 balance @ 10%	(11) 1/1/95 balance @ 10%	(12) 1/1/96 balance @ 9%
1/1/86	\$ 10,000	\$11,500									
1/1/87	10,000		24,510								
1/1/88	10,000			39,341							
1/1/89	10,000				55,756						
1/1/90	10,000					74,304					
1/1/91	10,000						94,420				
1/1/92	10,000							116,950			
1/1/93	10,000								139,645		
1/1/94	10,000									164,611	
1/1/95	10,000										190,323

\* Composite rate of return from Table II.

**Table IV**  
**Hypothetical Annual Account Balances\***

(1) Contribution Date	(2) Contribution Amount	(3) 1/1/87 balance @ 13.6%	(4) 1/1/88 balance @ 13.7%	(5) 1/1/89 balance @ 13.2%	(6) 1/1/90 balance @ 12.8%	(7) 1/1/91 balance @ 12.5%	(8) 1/1/92 balance @ 12.1%	(9) 1/1/93 balance @ 12.2%	(10) 1/1/94 balance @ 12.7%	(11) 1/1/95 balance @ 12.8%	(12) 1/1/96 balance @ 12.7%
1/1/85	\$ 10,000	\$11,340									
1/1/87	10,000		24,264								
1/1/88	10,000			38,725							
1/1/89	10,000				55,031						
1/1/90	10,000					73,029					
1/1/91	10,000						93,076				
1/1/92	10,000							115,632			
1/1/93	10,000								141,610		
1/1/94	10,000									171,015	
1/1/95	10,000										203,824

\*Rates of return based on hypothetical rates from Table I.

Table V

(1) Date	(2) Actual Annual Account Balances*	(3) Hypothetical Annual Account Balances**	(4) Insurance Payment
1/1/87	\$ 11,500	\$ 11,340	\$ 0
1/1/88	24,510	24,264	0
1/1/89	39,341	38,786	0
1/1/90	55,756	55,031	0
1/1/91	74,304	73,029	0
1/1/92	94,420	93,076	0
1/1/93	116,950	115,652	0
1/1/94	139,646	141,610	1,964
1/1/95	164,611	171,015	6,404
1/1/96	190,325	203,824	13,499

\*Figures from Table III.

\*\* Figures from Table IV.

2. *The Hypothetical Account Proposal and Insurance Premiums.*—Although insurance protection would provide greater protection against shortfalls in the expected retirement benefit, the payment of annual premiums would necessarily lower the net investment return for insured plan participants. Thus, in some instances the participants' actual investment return could be lower than the average return for uninsured accounts.<sup>234</sup> For example, assume that the average composite rate of return for a diversified portfolio is 10% in a particular year, and the annual guaranteed hypothetical rate of return is 9½%.<sup>235</sup> Further assume that the regular annual insurance premium is approximately 1% of the investment return. Therefore, in that year, participants electing defined contribution plan insurance would receive a less than average net return on their investments.<sup>236</sup> Specifically, insured participants would receive a net annual rate of return of 9%, (a 10% actual return less 1% paid for the premium) instead of the 10% annual return that an uninsured participant would receive.<sup>237</sup> Similarly, if the market suddenly performed better than average, at 12% for example, an insured participant would receive a lower net rate of return.

If the market suddenly performed substantially worse than average, however, the insured participant would receive a greater than average investment return. For example, assume that the annual composite investment return fell to 7% in the next year, and the annual hypothetical guaranteed rate of return was

234. The after-premium rate of return.

235. The annual hypothetical rate of return is based on the average rate of return of the hypothetical account for the five prior years.

236. This assumes that the annual guaranteed hypothetical rate of return is less than 10%.

237. The annual guaranteed hypothetical rate of return would be 10% minus 1% for the premium payment, or 9%.

9½%. The insured participants in that year would receive a net investment return of 8½%, which is 1½% above the uninsured participant's investment return.

3. *Noncompliant Investment Allocations.*—For the regular premium amount, insurance protection would be available to individuals who seek average returns by means of the diversification formula. An average rate of return would be guaranteed to individuals who take substantially lower than average risks, but only if they were charged an additional risk related premium. The additional premium would be economically derived to reflect the increased likelihood that such an account would earn significantly less than the minimum guaranteed rate of return. Therefore, paying higher premiums for below-average risk allocations, could be viewed as functionally equivalent to a participant investing their funds more aggressively.<sup>238</sup> As a result, in this situation, defined contribution plan insurance would not only guarantee some level of protection for accrued retirement benefits in defined contribution plans, but also would help to solve the problem of overly conservative investment practices.<sup>239</sup>

To illustrate, assume the same facts in the example above in which the annual guaranteed rate of return is 9½%, and the average composite rate of return for a diversified portfolio is 10%. Further assume that a conservative investment strategy yields 2% below the average market return, or 8% in this particular year. Also assume that the additional insurance premium charged for conservatively invested portfolios is 2% of the average investment return. Accordingly, under normal market conditions, a conservatively invested, insured participants would receive a net investment return of 7½%, which is 2½% less than an uninsured average return, and ½% less than she would have received had she not been insured and had invested conservatively.<sup>240</sup>

However, assuming the same 2% differential between average risk and below average risk portfolios used above, if the market performed substantially worse than average, at 7% for example, the under diversified uninsured portfolio would yield only a 5% rate of return. If it is assumed that the guaranteed annual rate of return is 9½%, the insured participant would receive a net investment return of 7½%, which is 2½% more than the uninsured conservative investor, and ½% more than the uninsured average risk investor.<sup>241</sup> Thus, under the

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238. For simplicity, it is assumed that the participant is 100% invested in stable-valued instruments; however, if a participant invested 100% in stable-value instruments, it would appear to be unnecessary to provide insurance protection as the assets would not be exposed to very much risk. Thus, it would be more likely that the participant invested somewhere between 100% and the prescribed percentage for stable-valued instruments.

239. See *supra* Part II.C.1.

240. That is, a guaranteed annual rate of return of 9½%, minus a 2% premium for the use of conservative investment strategy.

241. The 8½% return is based on the five prior year average of 9½% minus 1% for the premium payment.



proposed defined contribution plan insurance model, there are incentives for both the average risk taker as well as the less than average risk taker to insure against the risk of market fluctuations.

Insurance protection for the regular premium amount would not be available to those who take greater than average risk with respect to either investment category or risk classification, unless they demonstrated that special circumstances warranted a deviation from the prescribed diversification standard. For example, again assuming that the safe harbor formula were 60% stocks, 35% bonds, and 15% stable-value instruments, a participant very close to retirement who invested 85% in stable-value instruments and 15% in bonds, could still be eligible for insurance protection at the regular rate, if it could be shown that the allocation was not overly conservative in light of the participant's time horizon.<sup>242</sup> Under such a scenario, however, the participant would only be entitled to receive a level of insurance protection based upon a lower rate of return consistent with the asset mix for the regular premium amount. If, the noncompliant asset allocation neither comported with the prescribed diversification standards, nor satisfied a facts and circumstances test for the diversification requirement, insurance protection would be unavailable, unless an economically derived additional premium were charged.

4. *Private Insurers.*—The hypothetical insurance account model for defined contribution plan insurance could just as easily be offered by a private insurance company as by a federal agency.<sup>243</sup> Private insurers could compete for a share of the defined contribution plan insurance market by offering comparable insurance protection at a lower premium. If the private sector became involved, there would have to be some means by which the financial viability of the insuring companies could be evaluated and monitored by the federal government. Realistically, it is unlikely that the private sector could effectively compete because the premium charged by the federal government would more than likely always be less, since it could approach the insurance program as a revenue neutral activity. Thus, the private insurer, who would have to charge a premium sufficiently high to provide a profit margin, would be at a competitive disadvantage.

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242. Time horizon refers to the number of years left to save for retirement. This strategy would be used in order to provide protection against a down turn in the market with insufficient remaining time to offset such losses. A lower rate of return would be guaranteed consistent with the asset mix, however.

243. Subject to regulation by the government.

Interestingly, the private industry has not sought in any meaningful way to offer insurance to defined benefit plans under the current insurance system.<sup>244</sup> Perhaps one explanation is that under ERISA, PBGC insurance is mandatory for all employers who sponsor defined benefit plans.<sup>245</sup> Therefore, it is impractical for a private insurer to compete because an employer choosing private insurance would incur duplicate insurance costs.<sup>246</sup> If employers were permitted to substitute private insurance for PBGC protection, the private industry would be more likely to compete in the retirement plan insurance market.

Nevertheless, the existing defined benefit plan structure would seem to provide greater incentives for private competition than a defined contribution plan insurance program, because there can be funding surpluses in defined benefit plans.<sup>247</sup> The possibility of the insurer capturing a portion, or all, of a funding excess would appear to be sufficient to generate greater interest in insuring defined benefit plans. For example, an insurer of defined benefit plans could provide premium discounts in exchange for a pre-determined percentage of a plan surplus in the event of plan termination.<sup>248</sup> There are no such possibilities in a defined contribution insurance arrangement because there are no funding excesses in individual account plans. Therefore, the profits of an insurer of defined contribution plans would be limited to the difference in the insurance premiums charged and the payment of the minimum guaranteed rates of return.

#### F. *Regulating Defined Contribution Plan Insurance*

1. *The Moral Hazard Problem.*—Just as a disparity in risk allocation distinguishes defined benefit and defined contribution plans structurally, a disparity in risk allocation also distinguishes the insurability of these plans. When a defined benefit plan terminates with insufficient funds, the sponsoring

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244. A participant can obtain insurance on their own to the extent that insurance companies will provide insurance protection on an individual basis, but there is no established program which would spread the risks among numerous plan participants.

245. See Daniel Keating, Chapter 11's New Ten-Ton Monster: The PBGC and Bankruptcy, 77 Minn. L. Rev. 803, 806-07 (1993); see also *supra* Part I.A.

246. Unless the PBGC elected to give way to private insurance.

247. An excess occurs in a defined benefit plan when the assumptions used by the plan are more conservative than the experience of the plan. A plan's "experience" describes the actual cost of the plan. Actuarial gain or loss is measured by the difference between the actual cost of the plan and the actuarial estimates for a plan year.

248. When a plan terminates with excess assets, the employer is permitted to capture the excess. This is referred to as a reversion. The employer, however, must pay an excise tax on the reverted amount. Interestingly, in some instances, plans considered underfunded under IRC § 412 standards can have excess assets at plan termination because the actuarial assumptions for ongoing plans differ from those used in connection with terminating plans.

employer is primarily liable for the asset deficiencies. The PBGC is only secondarily liable.<sup>249</sup> Therefore, an employer who sponsors a defined benefit plan and does not anticipate insolvency is more likely to exercise caution to avoid exposing the plan assets to unreasonable investment risks.<sup>250</sup>

By contrast, when a defined contribution plan terminates with insufficient assets, there is no employer liability. Thus, a provider of defined contribution plan insurance would be primarily liable for any deficiencies that a participant experienced. Accordingly, the employer, or participant, making the investment decisions would have no incentive to avoid exposing the account to unreasonable investment risks.<sup>251</sup>

This concern expresses the moral hazard problem of insurance protection: those who are insured against certain risks have no incentive to use optimal care to avoid the insured risk.<sup>252</sup> For example, an employer sponsoring an insured money purchase plan, who recognized that it had no liability for plan losses, may invest disproportionately in high-risk, high-yield instruments in order to reduce the amount of future employer contributions necessary to reach a certain level of retirement benefit.<sup>253</sup> Alternatively, the employer may use the same strategy to increase plan benefits. However, a similarly motivated employer sponsoring a defined benefit plan would not choose to expose its plan assets to unreasonable risks because the employer would be liable for any asset deficiencies.<sup>254</sup>

Prior to the passage of ERISA, there was concern that the adoption of defined benefit plan insurance would also encourage abusive practices regarding risk exposure. Legislative history reveals that some policymakers specifically feared that defined benefit plan insurance would enable employers to promise excessively generous pension benefits in efforts to satisfy increasing labor

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249. Employers will pay either by providing the benefits or by reimbursing the PBGC. See *supra* note 12 and accompanying text.

250. If the employer anticipates insolvency, however, the employer may nevertheless take unreasonable risks knowing that the promised benefits would be paid by the PBGC.

251. Daniel Keating, *Pension Insurance, Bankruptcy and Moral Hazard*, 1991 Wis. L. Rev. 65, 66-67.

252. For purposes of defining moral hazard problems it is important to distinguish between two types of risks: reactive and fixed. A reactive risk is one over which the insured has some control. An example of this type of risk would be an automobile wreck due to controllable causes, such as speeding. A fixed risk is one for which the insured has no control, such as damage from floods and other acts of God. "For a moral hazard problem to exist, there must be some element of reactive risk involved." In other words, the insured must have some opportunity to exercise due care. *Id.* at 68.

253. A money purchase plan is a defined contribution plan that has a definite contribution formula. In contrast, a profit sharing plan is a defined contribution plan that can have an indefinite contribution formula.

254. The employer would be liable to the PBGC.

demands.<sup>255</sup> There was also concern that an employer might establish or amend a plan to provide substantial past service benefits, realizing that if funding were inadequate to pay the benefits, the PBGC would subsidize the remaining deficiency.<sup>256</sup> As a result, the pre-ERISA Committee determined that it was necessary to adopt safeguards against this type of abusive behavior. The Committee initially imposed restrictions on an employer's ability to recover from the PBGC. It required employers to reimburse the PBGC for asset deficiencies of up to 30% of the employer's net worth.<sup>257</sup> Subsequently, ERISA was amended to require that employers reimburse the PBGC for the full amount of the plan's funding deficiency.<sup>258</sup>

In connection with defined contribution plan insurance, it would be necessary to adopt similar protective measures to address the moral hazard problem. The prescribed diversification standard used in connection with the Hypothetical Account model discussed above accomplishes this goal by placing limitations on the level of risk to which an insured account may be exposed.<sup>259</sup>

*2. The Impact of Defined Contribution Plan Insurance on the PBGC.*—Skeptics of defined contribution plan insurance protection maintain that extending PBGC insurance protection to defined contribution plans would intensify the financial troubles of the PBGC.<sup>260</sup> This particular concern is valid, however, only if the defined contribution plan insurance program replicated or expanded the existing insurance program for defined benefit plans. A newly established defined contribution plan insurance program should do neither. A defined contribution insurance program should be uniquely designed to reflect not only differences in plan type and plan structure, but also recent awareness of design deficiencies in the defined benefit plan insurance program.<sup>261</sup>

Congress has conducted numerous studies to assess the strengths and weaknesses of the PBGC insurance program. These studies identify inherent problems with the PBGC insurance program, paying special attention to the mid 1980's, when the PBGC's liabilities began to increase.<sup>262</sup> Some studies have concluded that the PBGC's financial problems primarily stem from the potential liability of underfunded ongoing pension plans terminating. Other studies have

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255. See generally Langbein & Wolk, *supra* note 5, at 78-79.

256. See discussion *infra* Part IV.B, C.

257. See *supra* note 11 and accompanying text.

258. The Omnibus Budget Reconciliation Act of 1987 eliminated the 30% cap on the plan sponsors' liability.

259. See discussion *infra* Part IV.B, C.

260. See Langbein & Wolk, *supra* note 5, at 848-49.

261. See generally Keville, *supra* note 4, at 553-54.

262. Richard A. Ippolito, A Study of the Regulatory Effect of the Employee Retirement Income Security Act, 31 *J.L. & Econ.* 85 (1988) [hereinafter Ippolito, *Regulatory Effect*].

concluded that the real crux of the PBGC's funding crisis stems from the fact that the PBGC is not structured as a bona fide insurance company.<sup>263</sup>

Two characteristics distinguish the PBGC insurance program from the bona fide insurance model used in the private sector. First, the PBGC premium is not fully risk based.<sup>264</sup> As a result, healthy plans in thriving industries pay the same premiums as barely funded plans in troubled industries. Second, the PBGC premium is only partially economically derived.<sup>265</sup> Consequently, extremely well funded plans pay the same premium as plans that are only adequately funded. Although there are new increased variable rate premiums which require underfunded plans to pay higher premiums, there is still no corresponding adjustment to decrease the premiums of well funded plans.<sup>266</sup>

The failure to calibrate PBGC insurance premiums to fully reflect risk and cost results in a cross-subsidization from the beneficiaries of well funded plans to less well funded plans.<sup>267</sup> If a fully risk based insurance model were utilized for defined contribution plan insurance, employers or participants who invest in high-risk instruments would be required to pay more than those who invest at average risks.<sup>268</sup> Under such a model, the institution insuring the plan could be no better or worse off economically for having established the program.<sup>269</sup> As a practical matter, any proposal to federally insure defined contribution plans should not duplicate the shortcomings of the existing insurance

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263. See Richard A. Ippolito, *Pension Security: Has ERISA Had Any Effect?*, in Langbein & Wolk, *supra* note 4, at 91, 93 [hereinafter Ippolito, *Pension Security*]; Ippolito, *Regulatory Effect*, *supra* note 262, at 109-10.

264. See Ippolito, *Pension Security*, *supra* note 263, at 93; Ippolito, *Regulatory Effect*, *supra* note 262, at 85.

265. See Ippolito, *Pension Security*, *supra* note 263, at 93; Ippolito, *Regulatory Effect*, *supra* note 262, at 109-110. Studies show that the PBGC needs to impose a flat rate premium of at least \$50 per participant to pay for its expected future liabilities. See Ippolito, *Pension Security*, *supra* note 263, at 93. Even though the removal of the cap on variable premiums in 1994 was estimated to raise approximately \$650 million per year, the PBGC expected that their losses in future years will range between \$12 and \$20 billion. See Leigh Allyson Wolfe, *Is Your Pension Safe? A Call for Reform of the Pension Benefit Guaranty Corporation and Protection of Pension Benefits*, 24 Sw.U.L. Rev. 145, 154-55 (1994). Thus, even with its increased rates, the PBGC premiums still are not economically adequate.

266. "The flat-rate premium is \$19 per participant, and the variable premium is \$9 per \$1,000 of unfunded vested benefits with a maximum variable rate charge of \$53 per participant for a total maximum rate of \$72 per participant." Wolfe, *supra* note 265, at 154.

267. William H. Simon, *The Prospects of Pension Fund Socialism*, 14 Berkeley J. Emp. & Lab. L. 251, 256 (1993). A cross-subsidization of the beneficiaries as a class by the rest of the population can also occur if the insurance funds become insolvent and the federal government bails the companies out with general revenues. *Id.*

268. See Jefferson, *supra* note 26, at 40-41.

269. Plans covering employees of troubled industries would be charged more because there exists a greater risk of plan failure. See generally Ippolito, *Pension Security*, *supra* note 263, at 93-95 (contrasting the PBGC program with private insurance).

program. The defined contribution plan insurance program should be a new program with a risk-based premium. The Hypothetical Account model described in Part III.E is an example of such a program.

3. *The Problem of Bailouts.*—Some commentators have expressed concern that a defined contribution plan insurance program would increase federal exposure, possibly leading to a bailout similar to that of the 1980's saving and loan crisis. This is unlikely, however, because the need for the 1980 bailout developed out of circumstances unique to the savings and loan industry.

The savings and loan crisis occurred when savings and loan institutions promised high investment returns in order to attract greater numbers of investors and remain competitive in the financial lending market.<sup>270</sup> In efforts to generate sufficient income to pay the promised returns, the savings and loan institutions invested in short-term high-risk bonds. When the underlying businesses for the high-risk investments became insolvent, the savings and loans lost substantial sums of money. As a result, they were unable to meet their financial obligations as they became due. Therefore, it became necessary for the federal government to bail out the industry.

Like the savings and loans, defined contribution plan sponsors and participants would have incentives to maximize returns by investing in high-risk, high-return instruments.<sup>271</sup> However, the comparison between defined contribution plan insurance and the savings and loan crisis is nevertheless invalid. There were many factors in the savings and loan crisis which are inapplicable to the retirement system. First, there is an important distinction between the savings and loan industry and retirement plans with respect to cash flow. Funds placed in savings and loan institutions are available to depositors upon request. Therefore, when news that the savings and loans were experiencing financial difficulties reached the public, many depositors withdrew their funds from these institutions. This response made a bad situation worse.

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270. The savings and loan problem began in 1980 when interest rate legislation was passed which deregulated the liabilities (i.e., deposits), but not the assets of the savings and loans. Soon after, federal tax incentives were introduced in 1981 and 1982 which encouraged real estate projects to be undertaken that were not economically viable. During the same time, the federal government tightened the money supply, which caused government bond interest rates to rise. This situation forced the savings and loans to seek higher short term rates through junk bonds. Making matters worse, in 1986 oil plunged to \$10 a barrel, and the income tax incentives were taken away with no grandfather provisions. Also, one year later the stock market plummeted, and finally in 1989 the Financial Institution's Reform, Recovery and Enforcement Act (FIRREA) imposed higher capital standards on the thrift industry, creating a situation in which more savings and loan institutions had to be seized by the government than had been anticipated. Yakoboski, *supra* note 3, at 18.

271. Sponsors and participants would do so to achieve returns in excess of guaranteed rates.

In contrast, in retirement savings arrangements early distributions are generally disallowed unless specific events occur, such as early retirement, disability, or death.<sup>272</sup> Even when other early distributions are permitted by the plan, a 10% excise tax ordinarily applies to discourage participants from withdrawing their funds prior to retirement age.<sup>273</sup> Furthermore, an insurance program for defined contribution plans could impose additional restrictions on payment. Under the Hypothetical Account Model for defined contribution plans proposed in Part III.E, insurance protection would be unavailable until a participant attained normal retirement age, became disabled, or died, notwithstanding the distributable events allowed by the plans.<sup>274</sup> Thus, the distribution rules of ERISA, as well as additional restrictions imposed by the insurance program, would prevent a single event from increasing the volume of insured claims as it did in the savings and loan crisis.<sup>275</sup>

The second difference between the FSLIC's guarantee of savings and loan funds and a guaranteed benefit in a defined contribution plan program is industry diversification and its impact on the incident of failure. The funds guaranteed in the savings and loan crisis were exposed almost exclusively to the risk of a single industry, real estate. Thus, the savings and loan funds were extremely vulnerable to fluctuations in a particular market. By contrast, retirement plan assets are ordinarily more diversified. Specifically, defined contribution plan accounts in compliance with the diversification formula of the Hypothetical Account model described above, are required to be invested in multiple markets according to the prescribed portfolio mix.<sup>276</sup> Therefore, it is unlikely that defined contribution plans would fail as a result of the collapse of a single market. Moreover, because the guaranteed minimum benefit under the Hypothetical Account model would be based on a five-year average rate of return instead of the performance of a single year, there would be an additional measure of protection for the insurer.<sup>277</sup> As a result, any fluctuations in the market would be spread over a period of years.

The third difference between the savings and loan crisis and the retirement system is the presence of fraud and mismanagement. The savings and loan crisis did not result merely from aggressive investment activity. Fraud and

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272. See Regs. § 1.401-1(b)(1)(i).

273. Distributions before a participant reaches age 59½ are normally considered early. Exceptions to the 10% excise tax on early distributions are found in IRC § 72(t).

274. See discussion supra Part III.E.1.

275. Limitations on the insured amounts, such as those discussed in connection with the Hypothetical Account insurance model, would also prevent a brief period of fluctuations in the financial market from triggering the level of insurance claims filed during the savings and loan crisis. See Yakoboski, *supra* note 3, at 20.

276. See *supra* Part III.E.1.

277. See *supra* Part III.E describing the Hypothetical Account proposal.

mismanagement were present in approximately 60% of the savings and loan failures, and directly linked to the insolvency of at least 25% of the failed institutions, while evidence of fraud and mismanagement in pension plans is relatively low.<sup>278</sup> This fact alone suggests that a defined contribution plan insurance program would not be exposed to the same risk of failure that the savings and loan industry was exposed to in the 1980's.<sup>279</sup>

### G. *The Floor-Offset Pension Plan Comparison*

While the Hypothetical Insurance model discussed above proposes a new method of guaranteeing a minimum benefit in defined contribution plans, a minimum benefit in connection with defined contribution plans is not a totally new concept. A type of minimum benefit protection similar to that provided by the Hypothetical Defined Contribution Model currently can be achieved if an employer adopts a floor-offset pension plan.<sup>280</sup> Thus, insuring defined contribution plan retirement benefits is neither theoretically nor practically as different as one may initially believe.

A floor-offset plan, also known as a feeder plan, is a hybrid arrangement. While most hybrid arrangements are single plans which combine characteristics of both defined benefit and defined contribution plans, the floor-offset plan consists of two separate plans: a defined benefit and a defined contribution plan. The defined benefit plan is the "floor" plan. The floor plan uses a standard formula to establish a minimum benefit level that represent the employer's income replacement goals. The formula may take into account age, service, and compensation.

The defined contribution plan is the "base" plan. The employer makes the annual contributions to the base plan.<sup>281</sup> If the base plan provides a benefit

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278. See Yakoboski, *supra* note 3, at 20.

279. Another difference not discussed in the text of this article is the significance of loan participation in the savings and loan crisis. As the savings and loans found themselves constrained by limits on the amount they could lend to a single borrower, they began to sell portions of loans to other institutions. Many of the secondary lenders relied on the underwriting capacities of the originating savings and loans. Thus, the savings and loans were extremely vulnerable. Although a large proportion of defined benefit plan assets are placed in bank pooled funds and similar investments where investment results are shared, the investment strategy is fundamentally different. *Id.* at 20.

280. The majority of firms with floor-offset plans have between 5,000 and 20,000 employees, according to a study conducted by Robinson and Small in 1993. Typically, floor offset plans provide a floor benefit for a career employee of between 40 and 60% of pre-retirement compensation. EBRI, Special Report, *Hybrid Retirement Plans: The Retirement Income System Continues to Evolve 18* (1996) [hereinafter EBRI].

281. Any defined contribution plan can be used as the base plan in a floor-offset plan; however, the standard profit sharing plan is most frequently used in such arrangements.



at least equal to the minimum established under the floor plan, the participant receives the balance of the defined contribution account as her retirement benefit.<sup>282</sup> In such cases, no benefit is paid from the floor plan. If, however, the defined contribution plan provides less than the minimum benefit established under the floor plan, as a result of investment performance or inflation, for example, payments will be made from the floor plan to offset the shortfall in the base plan benefit.

The floor-offset plan is generally offered by employers who wish to maximize both the flexibility of defined contribution plans, and the retirement income security of defined benefit plans.<sup>283</sup> In a floor-offset plan, the employer typically is responsible for the investment of assets in both the defined benefit and defined contribution plans. If the participants rather than employers controlled the investments of the funds in the defined contribution base plan, in cases where the floor-offset plan was set at a sufficient level the participants would have incentives to invest in high-risk, high-yield instruments, knowing that the minimum benefit under the defined benefit floor plan would be adequate for retirement.<sup>284</sup> However, because the employer is the party making the investment decisions, and the one who bears the risk of a shortfall in the expected retirement benefit, the moral hazard problem is avoided.<sup>285</sup>

Interestingly, when the minimum benefit level in a floor-offset plan roughly approximates an average investment return on employer contributions over a participant's working life, the floor-offset arrangement provides a minimum retirement benefit guarantee very similar to the minimum benefit guarantee described under the Hypothetical Account proposal described in Part II.E. In both cases, participants are guaranteed receipt of a minimum benefit at retirement. The minimum benefit is calculated with reference to an expected return over the participant's working life. The major difference between the two guarantees is the source of the guarantee. In a floor- offset arrangement, the expected retirement benefit in the defined contribution plan is guaranteed through the defined benefit floor plan. In the Hypothetical Account proposal, a

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282. See EBRI, *supra* note 280, at 17.

283. Another situation for which a floor offset plan would be offered is a situation where the key employees are older and do not have sufficient time to accrue adequate retirement benefits under a traditional defined contribution plan. Thus, by offering a floor offset plan, these employees could be assured of receiving the desired level of income replacement at retirement from the defined benefit floor plan. See EBRI, *supra* note 280, at 18. As is the case with most hybrid retirement plans, there are many different plan designs. Because of the presence of both a defined benefit and a defined contribution plan, the floor offset plan may incorporate design features that are typically limited to one plan type or the other. *Id.*

284. See *supra* notes 251-61 and accompanying text.

285. Because the minimum benefit in a floor offset arrangement is provided by the defined benefit floor plan, the investment risk in a floor plan is substantially borne by the employer. See *supra* notes 252-54.

governmental agency similar to the PBGC guarantees the benefit through a bona fide insurance program.<sup>286</sup> In both cases the potential for the moral hazard problem of insurance protection is essentially eliminated. In the floor-offset plan, there is no moral hazard problem because the employer makes the investment decisions. In the Hypothetical Account Insurance Model, there is no moral hazard problem because the diversification standard restricts the use of overly aggressive investment strategies.

The use of floor-offset plans is not prevalent.<sup>287</sup> Because the floor-offset plan involves both a defined benefit and a defined contribution plan, the administration of such plans is more complicated than that of either type plan. Additionally, because the cost of the plan depends on the contributions made to the defined contribution offset plan and their investment build-up, a highly volatile portfolio in connection with the offset plan could result in losses and increase the funding of the defined benefit floor plan. Consequently, the cost of the floor plan could be more expensive than maintaining either a traditional defined benefit plan or a traditional defined contribution plan.<sup>288</sup> Therefore, most employers would not choose to provide floor-offset plans because of the additional costs and administrative burdens associated with maintaining floor offset plans.

Although the existence of the floor-offset plan demonstrates that the concept of defined contribution plan insurance is neither theoretically nor practically impossible, the limited use of such plans suggests that they have little impact on the retirement income security of the majority of defined contribution plan participants. Therefore, to ensure that more than a nominal percentage of defined contribution plan participants receive adequate protection against retirement benefit shortfalls, a guarantee of a minimum benefit should be available to all defined contribution plan participants through a defined contribution insurance program.

#### IV. FUNDING SHORTAGES IN DEFINED CONTRIBUTION PLANS

##### A. *Funding Under ERISA*

Pre-ERISA funding rules were not only inadequate in providing financial security for plan participants, but also created many problems related to

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286. See *supra* Part III.E.

287. See Cash Balance Pension Plans and Other Hybrid Retirement Plans, <<http://www.ebri.org/fundamentals/chpt10.html>>; see also EBRI, *supra* note 280.

288. Although some employers who establish floor-offset plans view the defined contribution plan as the primary retirement saving vehicle, many others view the defined benefit plan as the primary vehicle. Consequently, they recognize the defined benefit plan cost at all times. See EBRI, *supra* note 280, at 18.

underfunding.<sup>289</sup> Participants often did not receive the benefits they expected from plans that were in compliance with the existing funding rules.<sup>290</sup> Shortfalls in the expected retirement benefits are serious problems. Shortfalls threaten the financial security of plan participants not only because the retirement benefit received from the plan is more likely to be insufficient for the participant's retirement needs, but also because in reliance on their expected retirement benefits, participants are likely to have decreased personal savings. Furthermore, when the participant becomes aware of the shortfall, there likely will be too few years of employment remaining to appreciably increase personal savings to offset the loss of benefit.<sup>291</sup> As a result, when retirement plans are inadequately funded, participants may be worse off than they would have been in the total absence of a plan.

Therefore, in addition to strengthening the fiduciary rules and creating a federal insurance program, ERISA established minimum funding standards to help prevent funding shortfalls in qualified retirement plans.<sup>292</sup> The purpose of the funding standards is twofold. The funding standards not only provide greater

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289. One such case was the Studebaker case. This case made policymakers aware of the inadequacy of the existing funding requirements and consequently caused them to focus on plan funding and related matters. Thus, "the closing of the Studebaker automobile plant in South Bend, Indiana, in December of 1963 is regarded as a pivotal event" leading to the enactment of ERISA. See Langbein & Wolk, *supra* note 5, at 62. As a result of the plant closing, 5,000 workers were dismissed and 1,800 more eventually lost their jobs. *Id.* When the plant closed, the company entered into an agreement with the United Automobile Workers (UAW) for the termination of its pension plan. *Id.* at 63. "The termination agreement implemented the default priorities contained in the plan." *Id.* It divided the plan participants into three groups and paid their benefits accordingly: (1) 3,600 retirees and active workers who had reached the plan's normal retirement age of 60 received their full benefits in the form of life annuities, (2) 4,000 employees age 40 to 59 who had at least 10 years of service with the employer received lump sum payments representing approximately 15% of the actuarial value of their accrued benefits, and (3) 2,900 workers had no vested rights and received nothing. *Id.*

290. See also Jefferson, *supra* note 26, at 8-9.

291. See *id.* at 18-29.

292. See IRC § 412 (1998). The funding rules of this section are enforced with severe penalties. Any plan that fails to comply with the appropriate minimum funding standard must pay an excise tax equal to 10% of the underfunded amount, in addition to an interest charge. If the plan fails to correct the deficiency after receiving notification from the IRS that a deficiency exists, an excise tax of 100% of the deficiency is imposed. See Canan *supra* note 30, at 652. Plan costs are determined through actuarial valuations which estimate the cost of the plan and assign charges to the appropriate plan years as annual payments. In order to produce such estimates, the actuary must make assumptions about the future experience of the plan including the rate of investment return on plan assets, turnovers resulting in forfeitures of nonvested benefits, salary increases, the retirement age of plan participants, and the number of participants electing optional benefits offered by the plan. Thus, the amount that an employer is required to contribute in a particular year to properly fund a plan can vary tremendously depending on the actuarial assumptions used for each of these incidents.

retirement security to plan participants but also provide greater protection for the PBGC against underfunding in defined benefit plans.<sup>293</sup>

The minimum funding standards apply to all defined benefit plans, and some defined contribution plans.<sup>294</sup> Because they are required to have definite contribution formulas, money purchase plans and target benefit plans are two types of defined contribution plans which are subject to the minimum funding rules. Profit sharing plans are not subject to the minimum funding rules because they are not required to have a definite contribution formula.<sup>295</sup>

In a defined contribution plan, if the required contributions are not made and the plan terminates, there is no PBGC protection, although there would most likely be shortfalls in the expected retirement benefits. In a defined benefit plan if the required contributions are not made and the plan terminates, the employer and the PBGC would be liable for the payment of the expected retirement benefits. Thus, adequate funding is even more critical to the retirement income security of plan participants in defined contribution plans than in defined benefit plans, since neither the employer nor the PBGC is liable for the shortfalls.

Even though the funding rules do not require it, employers who sponsor defined contribution plans frequently fund toward ERISA's maximum permissible amount because of other considerations.<sup>296</sup> When defined contribution plans are funded toward specific income replacement goals, funding shortages can occur if insufficient contributions are made. Although the funding rules help to prevent deficiencies attributable to inadequate funding in defined benefit plans, they do little to prevent deficiencies attributable to inadequate funding in defined contribution plans.<sup>297</sup> For defined contribution plans, the funding rules require only that plans annually contribute amounts specified by

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293. Canan, *supra* note 30, at § 12.1, at 605. The funding rules require that employers contribute annually at least the normal cost of the plan and the amount necessary to amortize any unfunded liabilities over a period ranging from 15 to 40 years. See Jefferson, *supra* note 26, at 6; see also McGill & Grubbs, *supra* note 54, at 381-82.

294. Canan, *supra* note 30, at § 12.2, at 606. Money purchase plans and target benefit plans are subject to the minimum funding standards. The minimum funding standard for money purchase pension plans require the plan to contribute an amount which does not depend upon the uncertainties of actuarial assumptions. The rules are similar for target benefit plans. However, the funding rules provide that all pension plans—whether defined contribution or defined benefit—are subject to the IRC § 4971 excise tax, if the required contributions are not made to the plan. *Id.* The excise tax is 10% of the underfunded amount, and 100% of the underfunded amount if the underfunding is not timely corrected after notification by the IRS. *Id.* at 605.

295. Profit sharing plans are permitted to make discretionary contributions. Stock bonus plans, like profit sharing plans, are also excluded from the minimum funding standards.

296. IRC §§ 404.

297. However, most defined contribution plans are profit-sharing which are not subject to the minimum funding standards at all. See *supra* note 34, *infra* note 310 and accompanying text.

the plan's contribution formula.<sup>298</sup> Thus, in addition to inadequate fiduciary rules and the absence of insurance protection, inadequate funding rules are another reason defined contribution plan participants may not receive their expected retirement benefits.

### B. *Minimum Funding Standards and Past Service Credits*

As described in Part III, when a plan is established, a participant's expected retirement benefit consists of two parts: the portion attributable to future earnings and the portion attributable to past earnings.<sup>299</sup> While it is the entire retirement benefit that the participant ultimately relies upon, the two portions of the retirement benefit describe conceptually distinct benefits. Consequently, they are treated very differently for funding purposes.

Retirement benefits are deferred compensation. The benefits are earned during employment, but paid during retirement.<sup>300</sup> When a plan is newly established, the portion of the expected retirement benefit attributable to future years presumably will be funded by a reduction in current wages. For example, if a retirement plan provides an annual contribution of 10% of compensation and a participant earns \$50,000, the participant will receive a plan contribution of \$5,000.<sup>301</sup> In that same year the employee's wages would be reduced by a corresponding amount.<sup>302</sup> If the plan were to terminate the next year, theoretically, the employee's wages should increase.<sup>303</sup> From the additional compensation, the employee would be able to increase personal savings to offset any reduction in the expected retirement benefit that resulted from the plan's premature termination.

Therefore, because there is a corresponding increase in current wages which allows increased personal savings, participants could have no reasonable reliance on their expected benefits to the extent that they are attributable to future earnings. By contrast, however, if one believes that past service benefits are entirely related to past periods of service, theoretically, compensation from

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298. The funding rules have limited application to money purchase plans and target benefit plans. The rules have no applicability to profit sharing plans. See Canan, *supra* note 30, at 606.

299. Past service liability occurs when a retirement plan provides a benefit for service before the establishment of the plan or provides for retroactive benefit increases. See *supra* Part III.B.

300. This "commonly accepted modern account of pension obligations" is referred to as the deferred wage theory. See Langbein & Wolk, *supra* note 5, at 16.

301. Interest is not accounted for.

302. There are numerous theories as to the benefits' impact on compensation. See Veal & Mackiewicz, *supra* note 137, at § 12.1.1, at 205.

303. There is no adjustment for interest and the tax-free build-up.

previous periods would have already been cut, in order to fund the benefit attributable to past service. Consequently, if the plan terminates, to the extent that past service benefits have not been funded, a participant's current wages would not increase.<sup>304</sup> The participant, therefore, may be unable to increase personal savings to offset the reduction in the expected retirement benefit. This result suggests that it is reasonable for the participant to rely on the portion of the expected retirement benefit attributable to past service since there is neither a corresponding wage increase, nor sufficient time to offset a reduction in the expected retirement benefit.<sup>305</sup>

When a newly established plan gives credit for past service, the plan has an unfunded initial past service liability because the plan has liabilities for prior years of service, but no assets.<sup>306</sup> These liabilities are generally funded over a period of thirty years.<sup>307</sup> It is unlikely that such a plan will ever be fully funded, however, because ongoing plans typically fund not only the initial unfunded liability over thirty years, but also subsequent past service liabilities over additional thirty year periods. If a plan with past service credits continues in operation, liabilities for past service generally will not cause a funding shortage.<sup>308</sup> If the plan terminates before all of the funding periods have expired, however, the plan will have insufficient assets to cover the plan's accrued liabilities.<sup>309</sup> Thus, notwithstanding compliance with ERISA's minimum funding

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304. For example, consider a 64 year old participant. It would obviously have to be some other participant's wages that were reduced to fund the past service portion of the 64 year old's benefit.

305. See Jefferson, *supra* note 26, at 48.

306. For a more detailed discussion see Halperin, *supra* note 7, at 771.

307. Allowing past service credits to be funded over 30 years has been responsible for underfunding in a large number of plans. Because of concerns about funding inadequacies the Pension Protection Act of 1987 mandated more rapid funding of underfunded plans with more than 100 participants. ERISA § 302(d); IRC § 412(l). "For such plans, the minimum required contribution is the greater of (1) the amount determined under the normal funding rule, or (2) the sum of (a) normal cost, (b) the normal charges and credits reflecting changes in actuarial assumptions and net experience gains or losses, (c) the 'deficit reduction contribution,' plus (d) the 'unpredictable contingent event amount.'" See Langbein & Wolk, *supra* note 5, at 287. For plans in existence on January 1, 1974, the amortization period is forty years. See IRC § 412(b)(2)(B)(i).

308. The initial unfunded accrued liability can be funded over periods as short as 10 years or over periods as long as 30 to 40 years, depending on the effective date of the plan. See McGill & Grubbs, *supra* note 54, at 399. If, however, no additional amendments were made to the plan, the plan would be fully funded in exactly 30 years from its establishment date. See Halperin, *supra* note 7, at 771.

309. Payments for certain plan liabilities are projected over periods ranging up to 30 years; thus, when a plan terminates prematurely and all of its accrued liabilities become due and payable, the plan would most likely be unable to pay the retirement benefits of plan participants. However, inadequate funding can occur for numerous other reasons. The use of erroneous actuarial assumptions in the projection of future plan costs can either overstate plan assets or

standards, a plan can be inadequately funded on plan termination. As a result there would be insufficient assets to pay the portion of the benefit attributable to the past service credits.<sup>310</sup>

In defined benefit plans, the entire vested accrued benefit is insured after five years by the PBGC, including the portion of the benefit attributable to the past service credit. In defined contribution plans, no portion of the retirement benefit is insured, including the portion of the retirement benefit attributable to past service. Thus, if a defined contribution plan terminates prematurely, plan participants could experience shortfalls in both the past and future portions of their expected retirement benefits. This result is inappropriate if one accepts the theory that the portion of the expected retirement benefit attributable to past earnings in both types of plans is inherently different than the portion of the benefit attributable to future earnings. Conceivably, the past service benefits in all plans could be insured by the time a participant reaches normal retirement age, even if the future service benefits are not.

### *C. Past Service Liabilities in Defined Contribution Plans*

The rationale for requiring participants in defined contribution plans to assume the risk of adverse market conditions with respect to the accumulation of the future benefit does not adequately explain why they should be required to assume the risk with respect to the portion of their benefit attributable to previously earned amounts. Most defined contribution plans do not expressly distinguish between the portions of the benefit attributable to future costs and those attributable to past costs. In defined contribution plans, annual contributions are usually based upon a certain percentage of compensation.<sup>311</sup> For example, a plan may require the employer to annually contribute 10% of each participant's compensation, and there generally would be no explicit recognition of a liability for past service. It would therefore appear that defined contribution plan sponsors ignore service prior to the establishment date of the

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understate plan liabilities, resulting in plan losses. The adoption of plan amendments, which provide more generous plan benefits, can also create funding deficiencies.

310. The past service liability would not present a problem as long as the plan continues to operate because contributions would generally exceed the benefits paid out. See Halperin, *supra* note 7, at 771.

311. See Canan, *supra* note 30, § 3.52, at 174.

plan for purposes of allocating annual contributions.<sup>312</sup> However, this assumption is not necessarily correct.

Certain hybrid defined contribution plans explicitly award past service credits. The target benefit plan is an example of such a plan.<sup>313</sup> The target benefit plan computes the retirement benefit in the same manner as a defined benefit plan.<sup>314</sup> When a target benefit plan is established, a projected retirement benefit, or "target" benefit, is calculated for each participant.<sup>315</sup> The employer's annual contribution level is the sum of the amounts that are needed to annually fund each participant's targeted benefit.<sup>316</sup> The annual contribution is then allocated to the individual accounts according to the amount necessary to fund each participant's targeted benefit.<sup>317</sup> Because the target benefit plan uses a benefit accrual formula

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312. See Wayne J. Howe, *Education and Demographics: How do They Affect Unemployment Rates?*, 111 *Lab. Rev.* 3 (1998). The method of contributing under profit sharing and stock bonus plans provides the employer greater flexibility. In such plans employers are permitted to make annual discretionary contributions subject to certain limitations. See Canan, *supra* note 30, at 94. Plans having cash or deferred provisions generally do not take into account past service. However, there are certain ways in which they might. For example, a plan could permit a higher deferral percentage for employees with a certain length of service. Extreme care would have to be taken so as not to violate the antidiscrimination norms. *Id.* at 174.

313. After the annual contributions are determined and allocated, the target benefit plan operates like any other defined contribution plan. At retirement, the individual's account may be paid in a lump sum or used to purchase an annuity. However, the actual benefit could be more or less than the target benefit, depending on whether the actual investment earnings of the fund and the annuity purchase rates were more or less favorable than the actuarial assumptions used to calculate the contribution levels, or whether the plan did not terminate prematurely. See McGill & Grubbs, *supra* note 54, at 115. The target benefit plan is easier to administer than a traditional defined benefit plan. No actuarial valuations or reports are required. Thus, although the target benefit resembles a defined benefit plan in many respects, its allocation of investment risk is very different. As a defined contribution plan, the participant, bears the risk of unfavorable investment returns rather than the employer. Therefore, if the plan terminates early or if there is a substantial deviation in the experience of the plan as compared to the actuarial assumptions used by the plan, a participant's retirement benefit could differ drastically from the targeted amounts. Because the target benefit plan is an individual account plan, and the retirement benefit is based on the value of the participant's individual accounts, the target benefit plan is excluded from PBGC coverage. Therefore, there is no federal insurance protection for target benefit plan participants if the plan terminates with insufficient assets. See *id.*

314. See Halperin, *supra* note 8, at 176. See *Employee's Right to Convert Policy Not Incident to Ownership*, IRS Says, Vol. 11, No. 36, *Pens. & Ben. Rep. (BNA)* 1135 (Sept. 3, 1984).

315. The targeted benefit assumes that each participant will work until normal retirement age.

316. As is the case of all defined benefit plans, the target benefit plan provides higher contributions for older, more highly compensated employees.

317. See McGill & Grubbs, *supra* note 54, at 115. The contributions are determined by multiplying the target benefit by a factor in the plan that varies by age. *Id.*



to determine the retirement benefits,<sup>318</sup> it is possible for the employer to account for service prior to the establishment of the plan, by expressly awarding past service credits.

The use of past service credits in a target benefit plan is illustrated by the following example. Assume an employee age 45 has 10 years of service at the time a target benefit plan is established, and the plan recognizes past service. If the plan provides 1% per year of service, the employee can expect a 30% benefit at age 65, assuming the plan's investment performance is predicted accurately. The employee, accordingly, could assume a 10% benefit has already been earned when the plan is established.

If level contributions are made over the next 20 years, there will be sufficient assets when the employee attains age 65 to pay the entire expected retirement benefit. If the plan were to terminate at any point before the participant reaches age 65, however, there would be insufficient funds to pay the past service benefit, and the participant would receive less at retirement than she expected.<sup>319</sup> Thus, the participant would have been misled by the past service credit award.<sup>320</sup> The worst case scenario would occur at the end of year one. At this point the employee's account balance would fall significantly short of that required to provide an 11% benefit.

While the target benefit plan is the only defined contribution plan which allows the employer to expressly award credit for prior service, past service credit can be given implicitly in other types of defined contribution plans. For example, in a money purchase plan an allocation of employer contributions can be based on years of service, or on compensation.<sup>321</sup> In other types of defined contribution plans employers can take past service into account by permitting higher deferral percentages for employees with greater lengths of service.<sup>322</sup>

When an employer awards past service implicitly, it is more difficult to exactly determine the portion of the employer's annual contribution attributable to past service. Difficulty notwithstanding, it is nevertheless reasonable to assume that some portion of the annual contribution in defined contribution plans

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318. To the extent that the experience approximates the assumptions used to determine the projected benefit, the benefits will approximate those provided under a defined benefit plan with a benefit formula. The target benefit plan is even subject to the maximum limits on contributions which can limit the contributions that could otherwise be made to older participants. *Id.*

319. See Halperin, *supra* note 7, at 776-77.

320. But see *id.* at 772-78 (positing that we should treat past service in defined benefit plans like we treat it in defined contribution plans, which is to allow the same funding).

321. When this approach is used, care must be taken that such formulas are not discriminatory in favor of the highly compensated employees. See *Quality Brands, Inc. v. Commissioner*, 67 T.C. 167 (1976); See also Canan, *supra* note 30, at 98; see also Halperin, *supra* note 7, at 776; see also Regs. § 1.401-4(a)(2)(iii).

322. For example 401(k) plans. See *supra* Part I.A.

is made implicitly for prior service. Employers who sponsor defined contribution plans presumably would want to reward prior service for the same reasons that employers who sponsor defined benefit plans would. Therefore, even absent an explicit past service credit, a participant could reasonably consider her defined contribution plan as providing for past service when the plan is established.<sup>323</sup>

When credit for prior service is implicitly awarded, the portion of the annual contribution attributable to past service can be estimated, if the contribution level is known and certain assumptions are made. The annual accrual rate can be determined by dividing the expected retirement benefit by the participant's projected years of service. The future accrual rate can be determined by dividing the expected retirement benefit by the total years of projected future service. Taking the difference in these two results makes it possible to separate the portion of the projected benefit attributable to future earnings from the portion attributable to past earnings.

To illustrate, assume an employee with 15 years of service is age 50 when a defined contribution plan is established. Furthermore, the plan has a normal retirement age of 65, and the plan's annual contribution formula, which was derived with a specific income replacement goal, is 20% of compensation. Thus, the expected retirement benefit will accrue at a rate of 20% of the employee's annual compensation per year over the next 15 years.<sup>324</sup>

If the employee's future compensation and investment earnings rate on future accruals are assumed, the expected retirement benefit can be calculated when the plan is adopted.<sup>325</sup> For example, if annual compensation is expected to remain at \$50,000 over the next 15 years, and an investment return on the future contributions of 10% is assumed, the expected retirement benefit would be \$25,937.<sup>326</sup> If the expected retirement benefit is divided by thirty, the total years of service, the portion of the retirement benefit attributed to each year of service can be determined. In this example each year's accrual would be \$865 per year.<sup>327</sup> Thus, when the plan is established, the participant has already earned 15 years of accruals, or a benefit of \$12,975.<sup>328</sup> As a result, the participant should reasonably expect to receive at retirement a \$12,975 benefit for her prior years of service. This result occurs, however, only if some portion of each year's annual contribution is attributable to the funding of the past service liability.

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323. See Canan, *supra* note 30, at 174.

324. Plus an adjustment for interest.

325. If the contribution is known, the expected pension can be approximated by making assumptions about the period of service, the employee's salary, and the earnings on the fund. For simplicity, there is no salary scale increase used in this problem.

326.  $\$10,000 \times 1.10^{10} = \$25,937$ .

327.  $\$25,937/30 = \$865$ .

328.  $\$865 \times 15 = \$12,975$ .

If the plan continues to operate over the next 15 years, the participant would most likely be indifferent about whether any portion of the benefit was attributable to a past service credit, or not. This is because after 15 years the funding goal would be achieved, assuming the interest assumption were correct. However, if the plan were to terminate earlier, there would be insufficient contributions to cover the initial past service liability of \$12,975. As a result, the uninsured defined contribution plan participant would not receive the full past service benefit that she expected, and perhaps had already earned.

#### D. *The Funding Rules and Defined Contribution Plans*

In defined benefit plans, the distinction between past service and future service credits has substantial significance.<sup>329</sup> In defined benefit plans, whether liabilities are attributable to the future or to the past determines their tax treatment,<sup>330</sup> funding periods,<sup>331</sup> and the level of insurance protection they received.<sup>332</sup> Although the distinction between past service and future service theoretically exist in defined contribution plans, under current law the distinction has no practical significance in such plans. This is even true for target benefit plans which expressly award past service credits.

The inadequacies of the funding and insurance laws with respect to defined contribution plans is particularly evident in money purchase plans. Money purchase plans are subject to the minimum funding standards.<sup>333</sup> Employers are subject to substantial penalties if the plans they sponsor fail to comply with these rules.<sup>334</sup> Although the applicability of the funding rules to money purchase plans and target benefit plans may appear to provide additional protection to plan participants against shortfalls, there is no such protection. If a money purchase plan terminates prematurely and there have been insufficient contributions made to fund the past service portion of the expected retirement benefit, the participants will receive less than they expect at retirement. This would be the same result in other defined contribution plans which are not subject to the funding rules. Thus, the requirement that certain defined contribution plans comply with the funding rules is misleading. Participants are

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329. For example, as discussed earlier, past service must be amortized over 10 to 30 years, while current liabilities are expensed.

330. Generally, the maximum amount that an employer may deduct in a plan year is the sum of the normal cost and an amount sufficient to amortize the unfunded past service liability over ten years.

331. Future plan costs may not be funded in advance.

332. Future costs are not insured.

333. See IRC § 412.

334. See IRC § 4971.

given the false impression that their expected benefits are adequately funded since the plans are subject to ERISA's minimum funding standards.

The opportunity for misimpression is particularly well illustrated by the target benefit plan. Although the funding standards apply to target benefit plans, and the employer is allowed to expressly recognize prior service, there are nevertheless no additional funding requirements. Thus, a participant's retirement benefit could differ drastically from the targeted amount expressly stated in the plan. To avoid this result, Congress should amend the funding rules to have greater impact in their applicability to defined contribution plans. Similar to the treatment of defined benefit plans, employers sponsoring defined contribution plans subject to the funding rules should be required to annually contribute amounts necessary to fund the past service portion of the expected retirement benefit.<sup>335</sup>

Admittedly, such a change is likely to have relatively little effect. As discussed above, very few defined contribution plans explicitly award past service credits.<sup>336</sup> Consequently, only the few employers who sponsor target benefit plans that award past service credits would be affected by the more stringent funding requirements. Also, because the profit sharing plan, which is the most popular type of defined contribution plan, is not subject to the funding rules at all, such a remedy is not likely to have a meaningful impact on the majority of plan participants now covered by defined contribution plans.<sup>337</sup>

Therefore, the inadequacies of the funding rules as they apply to defined contribution plans make the argument for defined contribution plan insurance more compelling. Insurance protection is critically important for the retirement security of defined contribution plan participants because the funding rules do very little to protect them. At the very least, in defined contribution plans, the portion of the expected retirement benefit attributed to past service should be guaranteed. With slight modification, the Hypothetical Account Insurance Model discussed in part two of this article could very effectively be used for this purpose.<sup>338</sup>

## V. CONCLUSION

Participants who depend on defined contribution plans as their primary retirement savings vehicles are exposed to substantially greater risks of shortfalls

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335. For example, an employer sponsoring a target benefit plan that awarded a past service credit, would be required to make annual contributions in pre-determined amounts to cover the portion of the expected retirement benefit attributable to past service.

336. See *supra* Part IV.B.

337. See *supra* Part IV.C.

338. See Part III.E.

in their expected retirement benefits than participants in defined benefit plans. Those individuals who rely on participant directed plans are even more at risk. Because the existing fiduciary and funding rules are inadequate as they apply to defined contribution plans, there is a critical need for Congress to consider amending the pension laws to be more responsive to the risks of shortfalls in defined contribution plans. Moreover, because the gap in insurance protection further exposes defined contribution plan participants to plan losses, a defined contribution plan insurance program should be established.

Insuring defined contribution plans does in fact present difficult trade-offs. However, many of the concerns regarding such a program are reactionary rather than substantive. As for the relatively few substantive concerns, the overwhelming need to amend ERISA to be responsive to the current pension climate would appear to offset any difficulties that these concerns present. Therefore, notwithstanding the complexity of implementing a defined contribution plan insurance program, policymakers should seriously consider establishing an insurance program for defined contribution plans to meet the needs of future retirees.

Frequent and significant post-ERISA amendments that disproportionately affect defined benefit plans have led many to conclude that increased government regulation has been the impetus for the migration away from defined benefit plans to defined contribution plans.<sup>339</sup> Moreover, the regulations affecting defined benefit plans generally have been more burdensome than those affecting defined contribution plans.<sup>340</sup> Consequently, some skeptics of defined contribution plan reform may fear that increased regulation of defined contribution plans in connection with the fiduciary rules, insurance requirements, or the funding rules would adversely impact the establishment rate of defined contribution plans. Although frequent amendments have undoubtedly contributed in some measure to the shift from defined benefit plans to defined contribution plans, the magnitude of the effect of governmental regulation is probably grossly overstated.<sup>341</sup>

An analysis of current establishment trends reveals that numerous other factors are responsible for the shift from defined benefit plans to defined

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339. See Keville, *supra* note 4, at 534. This trend appears to apply to all work industries and all plan sizes. *Id.* at 536.

340. *Id.* at 535-37.

341. In some instances, new legislation affecting defined contribution plans has not only been less burdensome but has even relaxed existing restrictions. *Id.* For example, shortly after Congress increased the PBGC premiums paid by defined benefit plan sponsors in 1977, the attractiveness of defined contribution plans increased by introducing 401(k) arrangements making employee contributions tax deductible for the first time. The premiums were raised again in 1986 and then again in 1990. *Id.*

contribution plans.<sup>342</sup> Business considerations unrelated to pension plans are also responsible for an increase in the number of defined contribution plans. The introduction of 401(k) plans, and greater portability of defined contribution plans have also adversely affected the establishment of defined benefit pension plans.<sup>343</sup>

Even if government regulation affecting defined benefit plans has been more frequent than that affecting defined contribution plans, the number of changes does not necessarily indicate the significance of those changes. For example, while adjustments to the PBGC premium have been numerous, the premium, per employee, has remained relatively level over the past twenty years.<sup>344</sup> A nominal premium increase per participant is probably too small to make a significant difference in the employer's selection of a plan.<sup>345</sup> Similarly, it is unlikely that the introduction of a relatively low premium for defined contribution plans, or more stringent fiduciary rules in participant directed plans, would affect the establishment of these plans. This is true especially since other government regulations continue to place relatively smaller burdens on defined contribution plans than on defined benefit plans.<sup>346</sup>

A 1990 PBGC study supports the conclusion that the movement toward defined contribution plans is not solely in response to increased government regulation of defined benefit plans or additional plan costs.<sup>347</sup> Rather, the results of the study indicate that the primary cause of the recent decline in participation in defined benefit plans was a structural shift in the economy rather than conscious decisions made by plan sponsors and employees.<sup>348</sup> Small businesses typically prefer defined contribution plans; while large, unionized, manufacturing companies traditionally favor defined benefit plans.<sup>349</sup> Since most of the recent growth in American industries has occurred in the service and high technology area, more defined contribution plans have been established.<sup>350</sup>

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342. *Id.*

343. Because the net increase in defined contribution plans is far greater than the net decrease in defined benefit plans, it is reasonable to conclude that many workers, particularly those in small firms, who currently have defined contribution plans, previously would have had no plans at all rather than traditional defined benefit plans. Paul Yakoboski & Celia Silverman, *Baby Boomers in Retirement: What are Their Prospects?*, in *Retirement in the 21st Century: Ready or Not* 13.33 (Dallas L. Salisbury & Nora Super Jones eds., 1994).

344. The premium increase is relatively small if the amounts are adjusted for inflation.

345. See Halperin, *supra* note 8, at 160-61.

346. See generally, PBGC Study, *Consultants Concur, Plans Will Not Vanish in Future*, Vol. 17, No. 52 *Pens. & Ben. Rep.* (BNA) 2103 (Dec. 24, 1990).

347. PBGC studies show that the shift of smaller plans toward defined contribution plans is offset by the slight shift of larger plans toward defined benefit plans. *Id.*

348. See *id.*; see also Mark Daniels, *Pensions in Peril: Single Employer Pension Plan Terminations in the Context of Corporate Bankruptcies*, 9 *Hofstra Lab. L.J.* 25, 27-29 (1991).

349. See Canan, *supra* note 30, at 211-13.

350. See Keville, *supra* note 4, at 541-42.

