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Don't Put Your Eggs in One Basket: Reforming 401(k) Pensions to Address the Educational and Psychological Issues That Drive Good Employees to Make Bad Investment Decisions

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“Don’t Put Your Eggs in One Basket”: Reforming 401(k) Pensions to Address the Educational and Psychological Issues That Drive Good Employees to Make Bad Investment Decisions

Marvin H. Stroud*

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I. INTRODUCTION

In the early months of 2009, the United States faced the worst economic crisis since the Great Depression.¹ Recent events indicate that this dire outlook is more than hyperbole. Stock prices have recently seen a dramatic decline.² In February 2009, the Dow Jones hit a twelve-year low.³ In December 2008, the unemployment rate hit a sixteen-year high.⁴ The year 2008 also saw consumer spending at its lowest rates in twenty-eight years.⁵ This economic climate has forced a number of retailers to file for bankruptcy.⁶ Unfortunately, financial woes have not been limited to the retail sector; the crisis has deeply impacted the financial services sector as well.⁷

President Barack Obama has expressed that financial markets are in desperate need of reform.⁸ To this end, pension fund reform should be

1. See, e.g., Richard W. Stevenson, *Measuring a Victory*, N.Y. TIMES, Feb. 12, 2009, at A1 (reporting that President Barack Obama has “regularly suggested” that the current economic crisis “could rival the Great Depression”).

2. See Jeff Sommer, *Even for Market Veterans, It's Uncharted Territory*, N.Y. TIMES, Mar. 8, 2009, at B6 (reporting that, in the first two months of 2009, the Dow Jones industrial average had fallen almost twenty percent).

3. Jack Healy, *Buyers Flee as S.&P. and Dow Hit 12-Year Lows*, N.Y. TIMES, Feb. 24, 2009, at B1.

4. Jeannine Aversa, *Jobless Rate Jumps to 7.2 Percent in December*, SAN JOSE MERCURY NEWS, Jan. 9, 2009, available at http://www.mercurynews.com/ci_11414125?source=rss.

5. Jeannine Aversa, *Economy Shrinks at Fastest Rate in 26 Years*, ASSOC. PRESS, Jan. 9, 2009, <http://www.impomag.com/Scripts/ShowPR.asp?RID=10664&CommonCount=0> (on file with *McGeorge Law Review*).

6. E.g., Stephanie Rosenbloom, *Circuit City Going Out of Business*, N.Y. TIMES, Jan. 17, 2009, at B1 (“Last year, a raft of retailers, including Boscov’s, Sharper Image, Mervyns, Linens ‘n Things, Whitehall Jewelers and Steve & Barry’s, filed for bankruptcy protection. This week, Goody’s Family Clothing and Gottschalks also filed. Many more retailers are expected to follow suit as they run out of working capital or are unable to refinance their debt.”).

7. See David Olive, *The Year the Music Stopped: The Roller-Coaster That Was 2008 Brought Financial Giants and Everyday Investors Alike to Their Knees*, TORONTO STAR, Dec. 26, 2008, at B01 (reporting that in 2008 “some of the most storied names in high finance,” including “Merrill Lynch & Co., Lehman Bros. Holdings Inc., [and] Bear Stearns Cos.,” became “so racked with losses they had no choice but to surrender their independence in mergers with stronger entities”).

8. See Michael Powell & Jeff Zeleny, *Obama Casts Wide Blame for Financial Crisis and Proposes Homeowner Aid*, N.Y. TIMES, Mar. 28, 2008, at A19 (“Senator Barack Obama called Thursday for tighter regulation of mortgage lenders, banks and financial houses, even as he spoke of pumping \$30 billion into the economy to shield homeowners and local governments from the worst effects of the collapse of the housing bubble.”).

considered, since “[p]ension funds hold a staggering amount of assets.”⁹ Congress has repeatedly recognized the importance of ensuring that pension plans are stable and secure.¹⁰ The most notable piece of legislation advancing this goal is the Employee Retirement Income Security Act of 1974 (ERISA).¹¹ Congress enacted ERISA to ensure that workers are not twice-stricken by the tragedies of losing both their jobs and pension funds in the event that their employer goes out of business.¹² However, since employees are permitted to invest their 401(k) pensions in their employer’s stock, the danger that American workers can suddenly be thrown into complete financial disarray still remains.¹³

Commentators have proposed a wide variety of reforms to 401(k) pensions, including: limiting the amount of stock that can be invested in employee 401(k) plans,¹⁴ an outright ban on the use of the employer’s stock in 401(k) plans,¹⁵ requiring that an employer’s communications to its employees regarding the employer’s stock be disclosed to the SEC,¹⁶ scrutinizing the use of the employer’s stock for compliance with the employer’s fiduciary duties,¹⁷ requiring that an employer provide its employees with investment advice,¹⁸ and mandating that employers provide a pre-selected investment package as a “default” investment option for their employees.¹⁹

This Comment proposes that two amendments to Internal Revenue Code (IRC) section 401(k) are needed in order to protect employee pension

9. MARK A. ROTHSTEIN & LANCE LIEBMAN, *EMPLOYMENT LAW* 1168 (6th ed. 2007).

10. See, e.g., 29 U.S.C.A. § 1001(a) (West 2008) (“The Congress finds that . . . the continued well-being and security of millions of employees and their dependents are directly affected by [employee benefit] plans; that they are affected with a national public interest; [and] that they have become an important factor affecting the stability of employment and the successful development of industrial relations.”); see also 12 U.S.C.A. § 5201 (West Supp. 2009) (“[One of the] purposes of this chapter [is] . . . to ensure that such authority and such facilities are used in a manner that . . . protects home values, college funds, retirement accounts, and life savings.”).

11. Lorraine Schmall, *Defined Contribution Plans After Enron*, 41 *BRANDEIS L.J.* 891, 893 (2003).

12. Sharon Reece, *Enron: The Final Straw & How to Build Pensions of Brick*, 41 *DUQ. L. REV.* 69, 69 (2002).

13. See Shlomo Benartzi et al., *The Law and Economics of Company Stock in 401(k) Plans*, 50 *J.L. & ECON.* 45, 45 (2007) (stating that, because sixty-two percent of Enron’s 401(k) plan consisted of Enron stock, the company’s collapse decimated Enron’s employees’ retirement fund).

14. See, e.g., Pension Protection and Diversification Act of 2001, S. 1838, 107th Cong. § 2(a) (2001) (proposing to cap the amount of the employer’s stock that could be held in a 401(k) plan at twenty percent of the plan’s assets).

15. Richard L. Kaplan, *Enron, Pension Policy, and Social Security Privatization*, 46 *ARIZ. L. REV.* 53, 78 (2004).

16. Jennifer O’Hare, *Misleading Employer Communications and the Securities Fraud Implications of the Employee as Investor*, 48 *VILL. L. REV.* 1217, 1237-39 (2003).

17. Dana M. Muir, *The U.S. Culture of Employee Ownership and 401(k) Plans*, 14 *ELDER L.J.* 1, 10 (2006).

18. Janice Kay Lawrence, *Pension Reform in the Aftermath of Enron: Congress’ Failure to Deliver the Promise of Secure Retirement to 401(k) Plan Participants*, 92 *KY. L.J.* 1, 73 (2003).

19. Stephen F. Befort, *The Perfect Storm of Retirement Insecurity: Fixing the Three-Legged Stool of Social Security, Pensions, and Personal Savings*, 91 *MINN. L. REV.* 938, 981-82 (2007).

investments. The first amendment to IRC section 401(k) should require that pension plans contain a diversification component in order to qualify under the section. The second amendment that this Comment advocates would restrict 401(k) pension plans from consisting of the employer's securities, particularly the common stock.²⁰ This Comment argues that both amendments are necessary in order to respond to different weaknesses in the current 401(k) pension system. While the diversification component responds to participants' lack of financial savvy, the restriction on offering the employer's stock as an investment option responds to the psychological difficulties that participants may have when reconciling their role as "investors" with their duties as "employees."

In Part II, this Comment provides the historic and statutory background for employer-sponsored pensions, outlining how ERISA and section 401 of the IRC govern employee-sponsored pensions. In Part III, this Comment analyzes the current weaknesses in 401(k) pension laws, highlighting employee needs that must be addressed and employer interests that should be maintained. In Part IV, this Comment discusses how the proposed reforms will correct the existing weaknesses in 401(k) pension laws by addressing employees' educational, psychological, and practical needs, which the current system ignores.

II. BACKGROUND OF PENSION'S HISTORY AND GOVERNING STATUTES

A. *History and Purpose of Pension Funds*

The concept of employees enjoying an extended retirement is relatively recent.²¹ Pension advocates justified the need for pension funds for two reasons, the first being to ensure that the elderly members of society have the means to support themselves.²² The second goal of pension funds is to encourage older workers, who had declined in productivity, to voluntarily leave the company.²³ Following World War II, private pension plans gained in popularity, driven by

20. To be clear, this Comment is *only* arguing that employees should be banned from having their 401(k) accounts invested in their employer's stock. This Comment is not questioning the propriety of an employee independently purchasing her employer's stock or the employer issuing stock options as part of a benefit plan.

21. See William G. Gale & Peter R. Orszag, *Private Pensions: Issues and Options*, in AGENDA FOR THE NATION 183, 183 (Henry J. Aaron et al. eds., 2003) ("In 1900, nearly two out of every three men aged sixty-five or older were in the workforce."); see also F. Spencer Baldwin, *Old Age Pension Schemes: A Criticism and a Program*, 24 Q.J. ECON. 713, 713 (1910) (discussing the creation of pensions in Europe and North America during the late Nineteenth and early Twentieth Centuries).

22. Baldwin, *supra* note 21, at 714. Pensions are of critical importance to society, because without pensions many elderly persons would be forced to rely on public assistance. Kaplan, *supra* note 15, at 80.

23. Baldwin, *supra* note 21, at 714 ("The establishment of pension systems has, therefore, been proposed as a means of retiring employees at a reasonably early age and removing [the] handicap on industry."). Workers who do not have adequate financial resources to retire may be forced to work indefinitely, thereby decreasing the number of employment opportunities for younger workers. Kaplan, *supra* note 15, at 80.

employers' desire to attract and retain high-quality employees.²⁴ Today, "[t]he components of a financially secure retirement are often analogized to a three-legged stool," with the "three legs representing three sources of retirement income: (1) Social Security, (2) private pension plans, and (3) individual savings and assets."²⁵

Unfortunately, the three-legged stool appears to be built upon wobbly legs. At least one commentator predicts that a calamity that threatens retirees' economic future is looming.²⁶ In the coming years, the number of retirees is expected to grow much more rapidly than the number of taxpayers entering the workforce.²⁷ As a result, by 2017, Social Security payments are projected to exceed the amount of incoming tax.²⁸ By 2041, the Social Security Trust Fund is projected to be completely exhausted.²⁹ Additionally, personal savings have steadily dwindled over the past twenty years,³⁰ and from 2001 to 2006, "consumer debt grew approximately twice as fast as personal income."³¹ These converging circumstances present a bleak outlook for retirees.

B. Types of Pension Plans

Pension plans come in two different varieties.³² The first type is the "defined balance plan," which ERISA broadly defines as any type of pension plan that is not a defined contribution plan.³³ Traditionally, this type of plan "promises to pay each participant a set amount of money as an annuity beginning at retirement."³⁴

24. Befort, *supra* note 19, at 947. Employers also implemented pension plans in an effort to dissuade workers from joining labor unions. See ARCHIBALD COX ET AL., LABOR LAW 39 (14th ed. 2006) ("The large corporations were strongholds of anti-unionism, both through traditional weapons and newly developing benevolent personnel practices. 'Welfare capitalism' brought profit-sharing plans (usually short-lived), bonus systems, more rational systems of hiring and discipline through more scientific personnel management, and employee welfare plans that attempted to substitute 'company consciousness' for loyalty to craft.").

25. Befort, *supra* note 19, at 939.

26. *Id.* at 938.

27. *Id.* at 943-44.

28. *Id.* at 943.

29. *Id.*

30. *Id.* at 960.

31. *Id.*

32. See 29 U.S.C.A. § 1002(34) (West 2008) (specifying the aspects of a "defined contribution plan"); 29 U.S.C.A. § 1002(35) (West 2008) (defining the term "defined benefit plan"). "Cash balance plans" may be considered a third type of pension plan. Under ERISA, cash balance plans are classified as a type of defined benefit plan; however, these plans combine aspects of both traditional defined benefit plans and defined contribution plans. Regina T. Jefferson, *Striking a Balance in the Cash Balance Plan Debate*, 49 BUFF. L. REV. 513, 518-19 (2001). This type of plan uses "hypothetical accounts" to determine participants' pension benefits. See *Hirt v. Equitable Ret. Plan*, 533 F.3d 102, 105 (2d Cir. 2008) (describing the typical cash balance plan's framework). Since this Comment will focus on 401(k) plan reform, cash balance plans will not be discussed further.

33. 29 U.S.C.A. § 1002(35).

34. TWILA SLESNICK & JOHN C. SUTTLE, IRAS, 401(K)S, & OTHER RETIREMENT PLANS: TAKING YOUR MONEY OUT 10 (8th ed. 2007).

Payments are made “either as an exact dollar amount or as a calculated benefit through a service and salary formula.”³⁵ Instead of maintaining individual accounts, employers hold defined benefit plan assets together in a common pool.³⁶ While the employer is the plan’s principle guarantor, the Pension Benefit Guaranty Corporation insures pension benefits in the event that a plan becomes underfunded.³⁷

The second type of pension plan, called a “defined contribution plan” or “individual account plan,”³⁸ consists of “plan[s] which provide[] for an individual account for each participant and for benefits based solely upon the amount contributed to the participant’s account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant’s account.”³⁹ This type of plan came into existence in 1978, following amendments to the tax code.⁴⁰ This plan works by having either the plan participant or the employer “contribute pre-tax dollars to the employee’s individual account under the plan (sometimes at a set rate) and the account is invested for the employee.”⁴¹ Many different types of defined contribution plans exist, including, most notably for the purposes of this Comment, 401(k) plans.⁴² When a participant retires, the participant receives the value of his account.⁴³ In contrast to defined benefit plans, participants in defined contribution plans are at full risk for any losses suffered.⁴⁴

C. ERISA

1. ERISA’s Policy Aims

Prior to ERISA’s passage, employers often designed pension plans as conditional gifts, enabling employers to deny benefits to employees.⁴⁵ For example, in *Dodge v. Board of Education*, several groups of retired teachers filed suit to recover pension benefits.⁴⁶ One group of teachers argued that the “Miller Law,” which stated that retired teachers would receive \$1,500 annually, induced

35. Reece, *supra* note 12, at 77.

36. *Id.*

37. *Id.*

38. *Izzarelli v. Rexene Prods. Co.*, 24 F.3d 1506, 1509 n.1 (5th Cir. 1994).

39. *Id.* (quoting 29 U.S.C.A. § 1002(34)).

40. Schmall, *supra* note 11, at 899 (“Defined contribution plans had their genesis in the 1978 amendments to the tax code.”).

41. Reece, *supra* note 12, at 78.

42. *Id.*

43. *Id.*

44. *Id.*

45. *Id.* at 71-72.

46. 302 U.S. 74, 77 (1937).

the group to retire.⁴⁷ Rather than find the plaintiffs had a vested right to the \$1,500, the United States Supreme Court refused to accept the plaintiff's argument.⁴⁸ The Court noted that in Illinois, acts relating to retirement benefits "did not create contracts or vested rights and that the State was free to alter, amend, and repeal such laws even though the effect of its action was to deprive the pensioner or annuitant, for the future, of benefits then enjoyed."⁴⁹

Additionally, employers often abuse plan assets, resulting in retirees seeking government assistance to make up the difference.⁵⁰ For example, in 1963, 4,500 former Studebaker employees lost eighty-five percent of their pension benefits, because Studebaker's pension plan contained insufficient assets.⁵¹ Thus,

[o]ne of Congress' central purposes in enacting [ERISA] was to prevent the "great personal tragedy" suffered by employees whose vested benefits are not paid when pension plans are terminated. . . . Congress wanted to [ensure] that if a worker has been promised a defined pension benefit upon retirement—and if he has fulfilled whatever conditions are required to obtain a vested benefit—he actually will receive it.⁵²

2. Duties Imposed by ERISA

ERISA sets out the procedures for administering pension plans.⁵³ Pension plans are protected "through a combination of prohibitions, disclosures, and financial responsibilities aimed at providing security for employees and recourse in the event the employer or other fiduciary violates the rules."⁵⁴ Plan administrators are fiduciaries of the plan's beneficiaries.⁵⁵ As such, section 404 of ERISA imposes three duties upon plan administrators.⁵⁶ First, a plan administrator "shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries," taking special care to maximize benefits and limit costs for the plan's beneficiaries.⁵⁷ Second, a plan administrator must act "with the care, skill, prudence, and diligence under the circumstances

47. *Id.* at 80.

48. *Id.*

49. *Id.*

50. Reece, *supra* note 12, at 72 ("Additionally, company abuses of plan assets and failure to protect funds added to the probability that retirees would need to seek governmental assistance in old age.").

51. *Nachman Corp. v. Pension Benefit Guar. Corp.*, 446 U.S. 359, 374 n.22 (1980).

52. *Id.* at 374-75.

53. 29 U.S.C.A. § 1107(d)(3)(A) (West 1999) ("The term 'eligible individual account plan' means an individual account plan which is (i) a profit-sharing, stock bonus, thrift, or savings plan; (ii) an employee stock ownership plan; or (iii) a money purchase plan which was in existence on September 2, 1974, and which on such date invested primarily in qualifying employer securities.").

54. Reece, *supra* note 12, at 72.

55. 29 U.S.C.A. § 1002(21)(A) (West 2008).

56. *Id.* § 1104(a).

57. *Id.* § 1104(a)(1).

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.”⁵⁸ Third, a plan administrator has a duty to diversify “the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.”⁵⁹ Under section 409 of ERISA, fiduciaries who breach their statutory duties may be held “personally liable to make good to such plan any losses to the plan resulting from each such breach,” as well as being held liable under other equitable theories of relief.⁶⁰

In addition to the previously-mentioned fiduciary duties, ERISA requires that “a fiduciary shall discharge his duties with respect to a plan *solely in the interest of the participants and beneficiaries.*”⁶¹ However, the majority of circuits have held that “in general, an employer that decides to terminate, amend, or renegotiate a plan does not act as a fiduciary, *and thus cannot violate its fiduciary duty.*”⁶² In *Izzarelli v. Rexene Products Company*, Rexene Products Company (Rexene) established a savings plan under which it would match participants’ voluntary contributions.⁶³ In 1987, Rexene initially decided to contribute 101,794 shares to plan participants, based upon the amount of money each participant was paid during 1986.⁶⁴ After Rexene announced this contribution plan, Rexene’s accountants realized that the plan would have resulted in an over-contribution, in violation of the IRC.⁶⁵ The plan needed to be changed, but the new share contribution had to accomplish two goals. First, since Rexene was in the process of being sold, the new contribution plan could not make the company less attractive to buyers.⁶⁶ Second, Rexene had to formulate a contribution plan that would ensure that “heavy savers” would not frustrate Rexene’s sale.⁶⁷ Eventually, in order to comply with over-contribution restrictions, Rexene decided to “allocate to each participant shares valued at 6.32% of his or her 1986 considered compensation.”⁶⁸ “Rexene chose 6.32% because that percentage allowed it to allocate shares up to the [Internal Revenue Code] limits of most of the heavy savers.”⁶⁹ Under this revised plan, the 1986 participants only received the equivalent of 82,248 shares, not the 101,794 shares Rexene initially promised.⁷⁰

58. *Id.* § 1104(a)(1)(B).

59. *Id.* § 1104(a)(1)(C).

60. *Id.* § 1109(a).

61. 29 U.S.C.A. § 1104(a)(1) (West 2008) (emphasis added).

62. *Izzarelli v. Rexene Prods. Co.*, 24 F.3d 1506, 1524 (5th Cir. 1994).

63. *Id.* at 1509 n.2.

64. *Id.* at 1509.

65. *Id.* at 1510.

66. *Id.*

67. *Id.*

68. *Izzarelli*, 24 F.3d at 1511.

69. *Id.* at 1511 n.7.

70. *Id.* at 1512.

The 1986 plan participants brought suit against Rexene, alleging, among other things, breaches of fiduciary duty under ERISA.⁷¹ The *Izzarelli* court faced a situation where Rexene acted primarily out of self-interest, yet Rexene's share contribution plan ultimately benefitted the plan as a whole.⁷² The court held that "when an employer is also a fiduciary for its ERISA plans, it acts as a fiduciary 'only when and to the extent that [it] function[s] in [its] capacity as plan administrator[], not when [it] conduct[s] business that is not regulated by ERISA.'" ⁷³ Rexene acted as an employer, not as a fiduciary, when it amended its contribution plan.⁷⁴ Thus, Rexene's fiduciary duties were not breached.⁷⁵

Courts have interpreted ERISA's fiduciary duties as requiring administrators to act for the benefit of the pension plan, rather than for the benefit of any particular participant.⁷⁶ For example, in *Massachusetts Mutual Life Insurance Co. v. Russell*, the plaintiff alleged that the defendant breached its fiduciary duties by failing to timely pay the plaintiff her disability benefits.⁷⁷ The Supreme Court interpreted section 409 of ERISA as allowing recovery only if the plan, as opposed to a specific individual, suffers harm.⁷⁸ Thus, the plaintiff did not have a right of action for a breach of fiduciary duties.⁷⁹ Justice Stevens noted:

It is of course true that the fiduciary obligations of plan administrators are to serve the interest of participants and beneficiaries and, specifically, to provide them with the benefits authorized by the plan. But the principal statutory duties imposed on the trustees relate to

71. *Id.*

72. *Id.* at 1523.

73. *Id.* at 1524 (quoting *Hozier v. Midwest Fasteners, Inc.*, 908 F.2d 1155, 1158 (3d Cir. 1990) (internal quotations marks and citations omitted) (alterations in original)). A second line of cases provides that "an incidental benefit cannot 'legitimize' a fiduciary's improper (self-interested) motives." *Id.* at 1523 (citing *Deak v. Masters, Mates & Pilots Pension Plan*, 821 F.2d 572, 579-81 & n.12 (11th Cir. 1987), *cert. denied*, 484 U.S. 1005 (1988)).

74. *Izzarelli*, 24 F.3d at 1524-25.

75. *Id.* at 1525.

76. *See* *Mass. Mut. Life Ins. Co. v. Russell*, 473 U.S. 134, 142 (1985) ("A fair contextual reading of [ERISA] makes it abundantly clear that its draftsmen were primarily concerned with the possible misuse of plan assets, and with remedies that would protect the entire plan, rather than with the rights of an individual beneficiary."); *see also Izzarelli*, 24 F.3d at 1523 ("Plaintiffs read [ERISA section 404] to require Rexene to manage the Plan solely in the interest of 1986 Plan participants and their beneficiaries. But, a fiduciary's duty 'runs to the plan as a whole,' not to any individual beneficiary or group of beneficiaries."). *But see In re Schering-Plough Corp. ERISA Litig.*, 420 F.3d 231, 241-42 (3d Cir. 2005) (holding that a subgroup of 401(k) participants had standing to bring suit for breaches of fiduciary duty). In *Schering-Plough*, the plaintiffs represented "[a]ll persons who were participants in or beneficiaries of the Savings Plan at any time between July 29, 1998 and the present." *Id.* at 233. The plaintiffs alleged that the defendants breached their fiduciary duties "by continuing to offer the Company Stock Fund as one of the Savings Plan alternatives when they knew that Schering's stock price was unlawfully and artificially inflated." *Id.* The *Schering-Plough* court distinguished the instant case from *Russell* by reasoning that the *Russell* court did not foreclose on the possibility of a subgroup of plan participants bringing suit for ERISA violations. *Id.* at 241.

77. *Russell*, 473 U.S. at 136-37.

78. *Id.* at 140.

79. *Id.* at 148.

the proper management, administration, and investment of fund assets, the maintenance of proper records, the disclosure of specified information, and the avoidance of conflicts of interest.⁸⁰

In a concurring opinion, Justice Brennan indicated that under certain circumstances a person may bring suit under ERISA for an individualized injury caused by plan administrators.⁸¹ But Justice Brennan agreed with the majority that, in the case at hand, the plaintiff was not entitled to recover under section 409.⁸²

D. 401(k) Plans

Section 401(k) pension plans first came into existence as a provision of the Revenue Act of 1978.⁸³ Beginning in 1981, section 401(k) became subject to a variety of IRS regulations and congressional revisions.⁸⁴ In August 1991, the Internal Revenue Service issued a comprehensive set of final regulations.⁸⁵

Section 401(k) plans rose in popularity during the mid-1980s.⁸⁶ This may be due in part to the fact that, during the late 1970s and early 1980s, a number of direct benefit plans had failed.⁸⁷ Furthermore, the Pension Benefit Guaranty Corporation “was depleted to the extent that all plans were jeopardized.”⁸⁸ Congress intended the Revenue Act of 1978 to provide relief to employers by allowing employers to make pension contributions with stock instead of monetary funding.⁸⁹

80. *Id.* at 142-43.

81. *Id.* at 151-53 (Brennan, J., concurring) (“To the extent the Court suggests that administrators might not be fully subject to strict fiduciary duties to participants and beneficiaries in the processing of their claims and to traditional trust-law remedies for breaches of those duties, I could not more strongly disagree. . . . The legislative history demonstrates that Congress intended by § 404(a) to incorporate the fiduciary standards of trust law into ERISA, and it is black-letter trust law that fiduciaries owe strict duties running directly to beneficiaries in the administration and payment of trust benefits.”). Although Justice Brennan’s concurring opinion suggests that ERISA should be governed by the principles of trust law, IRC section 401 does not apply black letter trust law, even though the term “trust” is used within the statute. *See Tavannes Watch Co., Inc. v. Comm’r of Internal Revenue*, 176 F.2d 211, 215 (2d Cir. 1949) (“‘Trust’ is not a term of art or a fixed content, and its meaning for the purposes of [Internal Revenue Code section 165(a)] is not necessarily the same as under state law or as under other sections of the Internal Revenue Code.”). Thus, a “trust” established under IRC section 401 does not need to comply with state trust laws. *See id.* (“It is thus not conclusive that originally the parties decided not to set up what they called a ‘trust,’ for they were thinking of the payment of trustees’ fees and the accounting in court which would necessarily be required if a state-law ‘trust’ were established.”).

82. *Russell*, 473 U.S. at 150 (Brennan, J., concurring).

83. Schmall, *supra* note 11, at 899.

84. *Id.* at 900.

85. Reece, *supra* note 12, at 82-83.

86. *Id.* at 83.

87. Schmall, *supra* note 11, at 901.

88. *Id.* The Pension Benefit Guaranty Corporation provides minimum insurance to under-funded direct benefit pension plans. Reece, *supra* note 12, at 77.

89. Schmall, *supra* note 11, at 901.

Additionally, 401(k) plans gained popularity in response to a desire on the part of employees for pension plans to grow at a faster rate than what traditional defined benefit plans offered.⁹⁰ While 401(k) plans were originally intended to merely supplement traditional pension plans, “the 401(k) now serves as a primary source of retirement income for more than half of American families.”⁹¹ “Employees sought to maximize their retirement funds by assuming the risk of the stock market and foregoing the security of defined benefit plans.”⁹² Other reasons that employees find 401(k) plans attractive include the fact that participants can take “their money” with them if they change companies and that 401(k) plans are seen as being less exposed to employer modifications than traditional pension plans.⁹³

I. Statutory Background

Congress enacted section 401 of the IRC for two reasons: to ensure that highly compensated employees were not using pension plans to shelter income from taxation and to ensure that pension plans were not being used to favor highly compensated employees at the cost of excluding other employees.⁹⁴ For example, under section 401, “inequalities in vesting are discriminatory (even if contributions are comparable) if they operate, alone or with eligibility requirements, to effectively exclude so many employees from practical benefits of the plan that its value to the employee group as a whole is illusory.”⁹⁵

Section 401 lays out four basic requirements.⁹⁶ First, contributions to the trust must be made by the “employer, or employees, or both.”⁹⁷ Second, the plan may not be used for “purposes other than for the exclusive benefit of [the] employees or their beneficiaries.”⁹⁸ Third, the plan must meet minimum participation

90. Kara M. Klaas, Note, *Left in the Dark: Sarbanes-Oxley and Corporate Abuse of 401(k) Plan Blackout Periods*, 29 J. CORP. L. 801, 803 (2004).

91. *Id.* at 804.

92. *Id.* at 803.

93. ROTHSTEIN & LIEBMAN, *supra* note 9, at 1165.

94. *United States v. Hall*, 398 F.2d 383, 389 (8th Cir. 1968); *see also McClintock-Trunkey Co. v. Comm’r of Internal Revenue*, 217 F.2d 329, 331 (9th Cir. 1954) (“As has repeatedly been observed by the courts, the purpose of [Internal Revenue Code section 165(a)] was to insure that profit-sharing plans be operated for the welfare of employees in general and to prevent the trust device from being used for the benefit of shareholders; and to insure that it shall be impossible for any part of the corpus or income to be used for purposes other than the exclusive benefit of employees.”). Although *McClintock-Trunkey* refers to Internal Revenue Code section 165(a), not section 401, “[s]ection 401(a) was originally enacted as Section 162(a) of the Revenue Act of 1942 . . . [.] which substantially amended Section 165(a) of the Internal Revenue Code. . . . The section was reenacted as 1954 Code Section 401(a). . . .” *Myron v. United States*, 382 F. Supp. 590, 595 n.1 (C.D. Cal. 1974).

95. *Hall*, 398 F.2d at 390.

96. 26 U.S.C.A. § 401(a) (West 2002 & Supp. 2008).

97. *Id.* § 401(a)(1).

98. *Id.* § 401(a)(2).

standards.⁹⁹ Fourth, “the contributions or benefits provided under the plan [cannot] discriminate in favor of highly compensated employees.”¹⁰⁰

Tax liability attaches when a section 401(a)-qualified trust’s funds are distributed to the beneficiaries.¹⁰¹ Under section 401(k) of the IRC, profit-sharing or stock bonus plans can be considered qualified trusts under section 401(a).¹⁰² In order to be considered a qualified cash or deferred arrangement under section 401(k), the employee must have the ability to elect whether the employer will make contributions to the employee’s trust account or make cash payments directly to the employee.¹⁰³ Second, the trust’s proceeds cannot be released to the employee, unless an event specified by statute has occurred.¹⁰⁴ Third, employees have a non-forfeitable right to their accounts’ assets.¹⁰⁵ Finally, employers cannot set an excessive period of employment as a condition for participation.¹⁰⁶

2. How 401(k) Plans Work

Although there is some variety among the types of 401(k) plans,¹⁰⁷ the traditional 401(k) plan allows participants to have some of their pay directed into the account; participants do not pay income tax on this compensation until the money is withdrawn from the account.¹⁰⁸ Some employers encourage contribution by matching employee investments.¹⁰⁹ In order to encourage employees to invest in the employer’s stock, many companies only offer to match employee contributions that are being used to purchase the employer’s stock.¹¹⁰

Plan participants’ ownership of pension assets is restricted by the employer, as well as by government regulation.¹¹¹ For instance, prior to the passage of the Pension Protection Act of 2006, Enron and most other companies did not allow participants to sell company stock received as a matching contribution before the

99. *Id.* § 401(a)(3).

100. *Id.* § 401(a)(4).

101. *Id.* § 402(a).

102. 26 U.S.C.A. § 401(k)(1) (West 2002 & Supp. 2008).

103. *Id.* § 401(k)(2)(A).

104. *See id.* § 401(k)(2)(B) (stating that proceeds may be released to the participant if, for example, the employment relationship ends, the participant reaches the age of 59.5, or there is an instance of employee hardship).

105. *Id.* § 401(k)(2)(C).

106. *See id.* § 401(k)(2)(D) (stating that employers may not set “a period of service with the employer (or employers) maintaining the plan extending beyond the period permitted under section 401(a)(1)”).

107. For instance, a Roth 401(k) plan differs from traditional 401(k) plans, because “the tax benefits for Roth 401(k)s come when [the participant] take[s] distributions, which will be tax free so long as [the participant] meet[s] certain requirements.” SLESNICK & SUTTLE, *supra* note 34, at 9.

108. *Id.* at 8.

109. *Id.*

110. Klaas, *supra* note 90, at 805.

111. *Id.* at 804.

participant reached the age of 50.¹¹² Furthermore, “only 4% of plans let participants immediately exchange matching contributions of company stock.”¹¹³

3. Reforms Following Enron’s Collapse

Following Enron’s collapse, members of Congress presented numerous bills that would have reformed defined contribution plans.¹¹⁴ One such bill would have amended ERISA to prohibit a 401(k) plan from consisting of more than twenty percent of the employer’s stock.¹¹⁵ Another bill would have enabled an employer to either allow the company’s stock to be an investment option for plan participants or make matching contributions in the form of company stock, but employers could not have done both.¹¹⁶ However, the Bush Administration was critical of attempts to limit the amount of the employer’s stock held within a 401(k) plan.¹¹⁷ The Bush Administration argued that allowing employers to contribute to 401(k) plans with company stock, instead of cash, places a less onerous financial burden on the employer.¹¹⁸ Therefore, “employers who are precluded from making company stock matching contributions will respond by not making any matching contributions or by not sponsoring any pension plan at all.”¹¹⁹ Furthermore, some argue that any attempt to limit which investments an employee voluntarily makes is overly-paternalistic.¹²⁰

Eventually, Congress passed the Pension Protection Act of 2006 (PPA) to respond to the need for 401(k) pension reform.¹²¹ The PPA made two notable changes to pension laws.¹²² First, “[t]he PPA enable[d] plan participants to sell any employer-directed company stock match at any time beyond three years of receipt.”¹²³ Second, the PPA carves out an exception to the ban on fiduciaries

112. Reece, *supra* note 12, at 84. The Pension Protection Act of 2006 now provides that employees must be able to sell company stock received as a matching contribution within three years of receipt. 26 U.S.C.A. § 401(a)(35)(C) (West 2002 & Supp. 2008).

113. Reece, *supra* note 12, at 84 (quoting Christine Dugas, *Energy Giant’s Disaster Devastates 401(k) Plans; Dabacle [sic] Shows Risk of Loading up on Employer’s Stock*, USA TODAY, Nov. 30, 2001, at 1B).

114. Befort, *supra* note 19, at 979.

115. Pension Protection and Diversification Act of 2001, S. 1838, 107th Cong. § 2(a) (2001). Due to insufficient support, the author eventually withdrew the bill. Muir, *supra* note 17, at 11.

116. Protecting America’s Pensions Act of 2002, S. 1992, 107th Cong. § 101 (2002).

117. Befort, *supra* note 19, at 979; Lawrence, *supra* note 18, at 48-49.

118. Lawrence, *supra* note 18, at 49.

119. Befort, *supra* note 19, at 979; *see also* Lawrence, *supra* note 18, at 49 (“[O]pponents of overall limitations argue that employers are less likely to make employer contributions in the form of cash.”).

120. Befort, *supra* note 19, at 980. Section 401(k) plans are meant to allow employees “to maximize their retirement funds by assuming the risk of the stock market and foregoing the security of defined benefit plans.” Klaas, *supra* note 90, at 803. Thus, any attempts to restrict investment freedoms for the sake of investor protection would undercut this central policy.

121. Befort, *supra* note 19, at 980.

122. *Id.*

123. *Id.*; 26 U.S.C.A. § 401(a)(35)(C) (West Supp. 2008) (“In the case of a portion of the account attributable to employer contributions other than elective deferrals which is invested in employer securities, a

encouraging beneficiaries to make particular investments¹²⁴ by “provid[ing] a safe harbor for fiduciary advisors, including interested financial service firms, who give advice to participants on portfolio management, so long as they disclose conflicts and base advice upon an independently approved computer model.”¹²⁵

4. *The Employer’s Fiduciary Duties Related to 401(k) Plans*

In general, 401(k) trustees are subject to ERISA’s fiduciary and enforcement rules.¹²⁶ However, while ERISA provides that the employer’s stock cannot make up more than ten percent of a defined benefit plan’s fair market value,¹²⁷ this restriction does not apply to 401(k) plans.¹²⁸ Furthermore, if a participant is able to exercise control over her individual account assets, “no person who is otherwise a fiduciary shall be liable under [ERISA section 404] for any loss, or by reason of any breach, which results from such exercise of control.”¹²⁹ In other words, a 401(k) plan’s fiduciaries cannot be held liable for harm suffered as a result of a participant’s investment decisions, so long as the participant had the power to exercise control over her account and the participant is free to invest in a broad range of options.¹³⁰

Some plaintiffs have alleged that the act of offering the employer’s stock as an investment option for a 401(k) plan results in a breach of the employer’s fiduciary duties.¹³¹ Faced with these claims, courts have held that, when

plan meets the requirements of this subparagraph if each applicable individual who—(i) is a participant who has completed at least 3 years of service . . . may elect to direct the plan to divest any such securities and to reinvest an equivalent amount in other investment options meeting the requirements of subparagraph (D).”)

124. 29 U.S.C.A. § 1106(a) (West 1999).

125. Befort, *supra* note 19, at 980; *see also* 29 U.S.C.A. § 1108(g) (West Supp. 2008) (describing what steps must be taken in order for a fiduciary to provide financial advice to plan participants). A valid computer model must “appl[y] generally accepted investment theories,” take into account “relevant information about the participant” to “prescribe[] objective criteria to provide asset allocation portfolios comprised of investment options available under the plan,” avoid bias towards “investments offered by the fiduciary adviser or a person with a material affiliation or contractual relationship with the fiduciary adviser,” and ensure that participants’ assets are “not inappropriately weighted with respect to any investment option.” 29 U.S.C.A. § 1108(g)(3)(B).

126. *See In re Schering-Plough Corp. ERISA Litig.*, 420 F.3d 231, 235-36 (3d Cir. 2005) (reasoning that losses suffered by individual plaintiffs do not foreclose on the possibility that a defendant breached its ERISA duties to the pension plan).

127. 29 U.S.C.A. § 1107(a)(3)(A) (West 1999).

128. *See id.* § 1107(b)(1) (“Subsection (a) of this section shall not apply to any acquisition or holding of qualifying employer securities or qualifying employer real property by an eligible individual account plan.”).

129. ERISA Section 404(c) Plans, 29 C.F.R. § 2550.404c-1(a)(1) (2008).

130. *Id.* § 2550.404c-1(b).

131. *See, e.g., Nelson v. IPALCO Enters., Inc.*, 480 F. Supp. 2d 1061, 1096 (S.D. Ind. 2007).

Plaintiffs contend that the defendants breached the ERISA fiduciary duties of loyalty and prudence in three principle ways. First, plaintiffs contend that the defendants breached their duties by failing to remove IPALCO and then AES stock as investment options for Thrift Plan members. Second, plaintiffs contend that the defendants breached their duties by promoting investments in IPALCO and AES and by failing to disclose their own sales of all or nearly all of their own IPALCO and AES stock.

employers offer company stock as an investment option for a defined contribution plan, there is a rebuttable presumption that the employer has acted in accordance with ERISA's fiduciary duties.¹³² As the court explained in *Graden v. Conexant Systems, Inc.*, when a plaintiff alleges an employer breached its fiduciary duties by offering its stock as a pension plan investment option, there are three possible standards of review a court may apply.¹³³ First, "[w]here the plan *requires* investment in a particular stock, the fiduciary's conduct is not subject to judicial review."¹³⁴ Yet, "where the plan *merely permits* investment in a particular stock, the fiduciary's investment decision is subject to de novo review."¹³⁵

The court in *Moench v. Robertson* established the third standard of review, stating that "an [employee stock ownership plan] fiduciary who invests the assets in employer stock is entitled to a presumption that it acted consistently with ERISA by virtue of that decision."¹³⁶ Other circuits have expanded the holding in *Moench*, applying the standard to 401(k) plans and other eligible individual account plans.¹³⁷

The *Moench* presumption is applied when "the fiduciary is 'not absolutely required to invest in employer securities,' but is 'more than simply permitted to make such investments.'"¹³⁸ In order to rebut the *Moench* presumption, a plaintiff must not only allege a sharp decline in the price of the employer's stock, but also that:

Id. In order to make out a claim that the defendant breached its fiduciary duties by offering its stock as an investment option, the plaintiff does not need to prove that the defendant was dishonest. *Id.* at 1096-97. Ultimately, the court will analyze whether offering the defendant's stock as an investment option was a breach of fiduciary duty by applying the *Moench* presumption and by evaluating whether the defendant viewed the stock "as an appropriate and suitable investment option . . ." *Id.* at 1099.

132. *E.g.*, *Moench v. Robertson*, 62 F.3d 553, 571 (3d Cir. 1995), *cert. denied*, 516 U.S. 1115 (1996).

133. 574 F. Supp. 2d 456, 462-63 (D.N.J. 2008).

134. *Id.* at 462 (citing *Moench*, 62 F.3d at 571).

135. *Id.* The *Graden* court evaluated one of the defendant's pension plans (referred to as the "Amended Plan"), which did not require the employer's stock to be offered as an investment option under the *Moench* presumption. *Id.* at 463-64. The *Graden* court determined that the plaintiffs, who alleged that the defendants knew or should have known that the business was facing financial troubles, stated sufficient facts for the court to dismiss the defendants' 12(b)(6) motion to dismiss. *Id.* at 464.

136. *Moench*, 62 F.3d at 571.

137. *Graden*, 574 F. Supp. 2d at 463 (citing *Edgar v. Avaya, Inc.*, 503 F.3d 340, 347 (3d Cir. 2007)); *see also In re Radioshack Corp. ERISA Litig.*, 547 F. Supp. 2d 606, 613 (N.D. Tex. 2008) (citing *Langbecker v. Elec. Data Sys. Corp.*, 476 F.3d 299, 308 & n.19 (5th Cir. 2007)) (stating that the Fifth Circuit has adopted the Third Circuit's reasoning in regards to *Moench*). However, not all circuits have adopted the *Moench* presumption. *See In re Fremont Gen. Corp. Litig.*, 564 F. Supp. 2d 1156, 1158 (C.D. Cal. 2008) (quoting *In re Syncor ERISA Litig.*, 516 F.3d 1095, 1102 (9th Cir. 2008)) ("[T]his Circuit has not yet adopted the *Moench* presumption . . . and we decline to do so now."). Instead, the Ninth Circuit looks at a number of factors to determine if an employer breached its fiduciary duties by offering the employer's stock as a defined contribution plan investment option, including whether "a company's stock was artificially inflated by an illegal scheme about which the fiduciaries knew or should have known." *Fremont General*, 564 F. Supp. 2d at 1158.

138. *Graden*, 574 F. Supp. 2d at 462-63 (quoting *Moench*, 62 F.3d at 571).

[The] defendant[] [knew] of the stock's "impending collapse" and the defendants' "own conflicted status" created the type of "dire situation" in which the defendants should have disobeyed the plan's direction to make employer stock an investment option or divested the plan of company stock in order to fulfill their fiduciary obligation to the plan and its participants.¹³⁹

Some courts, without expressly adopting the *Moench* presumption, have applied a similar approach to determine whether an employer should have removed its stock as a pension plan investment option.¹⁴⁰

III. PROBLEMS WITH 401(K) PLANS

A. Employee Needs That Must Be Addressed

1. Employees Face Danger by Placing Both Immediate and Long-Term Financial Dependence upon the Employer

Financial experts recommend that employees invest no more than ten percent of their pensions in a single company.¹⁴¹ Employees who invest in their employer's stock have a stake in the company greater than that held by other investors—employees are reliant upon the employer for their paychecks, and often other benefits, such as health care.¹⁴² As a result, employees who invest heavily in their employer's stock are faced with the possibility of losing both their jobs and their retirement funds.¹⁴³ For example, in 1963, the Studebaker Corporation closed one of its factories, resulting in almost 10,000 workers losing their jobs.¹⁴⁴ Compounding matters, nearly 4,000 of those workers lost eighty-five

139. *Id.* at 463 (quoting *Edgar v. Avaya, Inc.*, 503 F.3d 340, 348 (3d Cir. 2007)). The *Graden* court evaluated a second pension plan provided by one of the defendants (referred to as the "Former Plan") under the *Moench* presumption. *Id.* at 463-64. Under this standard, the *Graden* court held that allegations that the defendants knew that the employer's stock price was likely to drop, and that certain corporate officers acted to conceal this fact from the plaintiffs, was not sufficient to overcome the *Moench* presumption. *Id.*

140. *See Sherrill v. Federal-Mogul Corp. Ret. Programs Comm.*, 413 F. Supp. 2d 842, 859 (E.D. Mich. 2006).

Plaintiffs' allegations go beyond simply suggesting that the Retirement Committee failed to override the terms of the Plan. Indeed, [the plaintiffs] allege that the Retirement Committee, as Plan fiduciaries, failed to take any action that might protect participants' assets in the Plan. These allegations of failing to take action may . . . reveal factual background relating to the Retirement Committee's discretionary acts of plan management or administration that would come within the scope of an ERISA fiduciary duty.

Id.

141. O'Hare, *supra* note 16, at 1220; *see also* Benartzi et al., *supra* note 13, at 47 ("Encouraging or forcing employees to invest in a single stock, rather than a diversified fund such as a mutual fund, violates the first principle of investing—to diversify!").

142. Kaplan, *supra* note 15, at 76.

143. *Id.*; Reece, *supra* note 12, at 70.

144. Reece, *supra* note 12, at 69.

percent of their pension benefits in the wake of the factory closure.¹⁴⁵ This is a scenario that ERISA was intended to prevent.¹⁴⁶

Under existing law, however, the use of 401(k) plans can lead to similar tragedies. For example, at the time of Enron's collapse, sixty-two percent of the assets in the company's 401(k) plan consisted of Enron stock.¹⁴⁷ Enron's employees not only lost their source of immediate income, but also much of their retirement savings.¹⁴⁸ Even though nearly four decades separated the collapses of Studebaker and Enron, both companies' employees suffered largely the same fate.¹⁴⁹

Exacerbating the problem is the fact that the courts have truncated many ERISA protections that would guard against workers over-investing in their employers.¹⁵⁰ For example, the *Izzarelli* court essentially gave employers the ability to make self-dealing changes to defined contribution plans, so long as the plans receive some sort of incidental benefit.¹⁵¹ Since the employer only needs to act for the benefit of the plan as a whole, any subgroups who may be harmed by the employer's self-interested changes would not have a right of action for ERISA violations.¹⁵²

Furthermore, employees bear a heavy burden in proving that the employer should not have provided its stock as an investment option. Plaintiffs must demonstrate that the poor results of investing in the employer's stock were foreseeable.¹⁵³ Even if this initial showing is met, the *Moench* presumption sets a very high pleading bar for aggrieved plaintiffs.¹⁵⁴ In *Graden*, the plaintiffs alleged that the defendants knew that the employer's stock price was likely to drop and that corporate directors acted to conceal that fact from the pension plan

145. *Id.*

146. *Id.* at 72.

147. Benartzi et al., *supra* note 13, at 45.

148. *Id.*

149. *See, e.g.,* Reece, *supra* note 12, at 69 (stating the effects of Studebaker's factory closure on its employees); Benartzi et al., *supra* note 13, at 45 (describing the effects of Enron's collapse on its employees).

150. *See Izzarelli v. Rexene Prods. Co.*, 24 F.3d 1506, 1524 (5th Cir. 1994) (limiting the scope of activities that would trigger an employer's ERISA fiduciary duties); *see also* *Moench v. Robertson*, 62 F.3d 553, 571 (3d Cir. 1995) (holding that ESOP fiduciaries are entitled to a presumption that they acted in accordance with ERISA's fiduciary requirements when offering employer stock as an investment option).

151. *See Izzarelli*, 24 F.3d at 1523 (citing *Deak v. Masters, Mates & Pilots Pension Plan*, 821 F.2d 572, 579-81 & n.12 (11th Cir. 1987)) (stating that employers should not be allowed to legitimize self-dealing by providing an incidental benefit to the pension plan). The *Izzarelli* court declined to follow the approach used by the *Deak* court; instead the *Izzarelli* court restricted the scope of fiduciary duties imposed by ERISA. *Id.* at 1523-25.

152. *See id.* at 1523 ("[A] fiduciary's duty 'runs to the plan as a whole,' not to any individual beneficiary or group of beneficiaries.").

153. *See, e.g.,* *Nelson v. IPALCO Enters., Inc.*, 480 F. Supp. 2d 1061, 1099 (S.D. Ind. 2007) (reasoning that an employer cannot be held liable if one could have viewed the employer's stock as "as an appropriate and suitable investment option").

154. *See Graden v. Conexant Sys., Inc.*, 574 F. Supp. 2d 456, 463 (D.N.J. 2008) (stating that a plaintiff must show the employer's stock is facing "impending collapse," and that the employer was acting out of self-interest in offering its stock as a defined contribution plan investment option).

participants.¹⁵⁵ However, these facts were not sufficient to demonstrate the sort of “dire situation” that would overcome the *Moench* presumption.¹⁵⁶

2. Employees Generally Lack Financial Knowledge

Given that participants in 401(k) pension plans are responsible for making their own investments, it is crucial that participants have some investment expertise.¹⁵⁷ Yet, in general, the American public lacks the financial knowledge to make sound investment decisions.¹⁵⁸ Numerous studies have revealed that the vast majority of employees fail to realize that investing in their employer’s stock is riskier than assembling a diversified pension portfolio.¹⁵⁹ Even after Enron’s collapse, the majority of employees believe that investing in their employer’s stock is less risky, or is equally as risky, as investing in a diversified stock fund.¹⁶⁰

Furthermore, American culture tends to focus on short-term results.¹⁶¹ According to one study, which examined, among other things, how different societies value long-term orientation characteristics, such as thrift, against short-term orientation characteristics, such as an expectation for quick results, found that “the United States ranks relatively low on the scale of long-term orientation, tending to be more short-term.”¹⁶² This implies that Americans may be vulnerable to making short-term investments with their retirement accounts and consequently failing to plan for long-term security.¹⁶³

155. *Id.* at 463-64.

156. *Id.*

157. Susan Griffith, *How Does America Score on Financial Knowledge? Case Professor to Discuss GAO’s National Financial Literacy Forum*, CASE W. RES. U. NEWS CENTER, July 29, 2004, http://www.case.edu/news/2004/7-04/previts_gao_forum.htm (on file with the *McGeorge Law Review*).

158. *Id.*; see also Young Americans Center for Financial Education, Financial Literacy Statistics, <http://www.yacenter.org/index.cfm?fuseAction=financialLiteracyStatistics.financialLiteracyStatistics> (last visited Mar. 19, 2009) [hereinafter Financial Literacy Statistics] (on file with the *McGeorge Law Review*) (reporting that “[o]f the 6,000 students who took the Jump\$tart personal finance survey in 2006, 62% received failing scores with 60% being the lowest passing grade”).

159. Benartzi et al., *supra* note 13, at 53 (“For example, John Hancock Financial Services (1999) reports that only [eighteen] percent of employees realize that their employer’s stock is riskier than a stock fund.”).

160. See *id.* at 54 (reporting that twenty-five percent of respondents stated that investing in the employer’s stock is less risky than investing in a diversified stock fund, and thirty-nine percent of respondents stated that investing in the employer’s stock is equally as risky as investing in a diversified stock fund).

161. Muir, *supra* note 17, at 4-5 (noting that the United States placed twenty-seventh out of thirty-four countries examined).

162. *Id.*

163. See Franklin Templeton Investments, *Why Diversify*, http://www.franklintempleton.ca/ca/retail/en/jsp_cm/education/life_planning/why_diversify.jsp (last visited Mar. 19, 2009) [hereinafter *Why Diversify*] (on file with the *McGeorge Law Review*) (“For investors to achieve their investment goals, a steadfast focus on long-term investment goals is required. Making changes to a portfolio in response to market movements can be costly; thinking in the short term can cause investors to miss out on the gains when the markets bounce back—and the markets always bounce back.”).

3. *Employees Are Vulnerable to Being Misled by Their Employer's Fraudulent Representations*

While companies typically communicate with their investors through public correspondence, employers can communicate investment information about the company's stock to its employees through a number of informal methods, including company newsletters, staff meetings, internal memoranda, and emails.¹⁶⁴ These types of communications "are not required to be filed with the SEC."¹⁶⁵ Since these informal communications are not publicly disclosed, the employer's representations of its stock's stability will not be scrutinized by analysts or journalists.¹⁶⁶

Without public scrutiny, an employer that makes misleading statements about the company's stock to its employees through informal forms of communication is unlikely to be subject to discipline.¹⁶⁷ Attorneys who specialize in securities litigation often review press releases for misleading statements; since informal forms of communication are not made publicly available, these attorneys would never be aware of when misleading statements were made.¹⁶⁸ Furthermore, because informal communications are not disclosed to the SEC, there is no chance that the Commission would bring an action against an employer that makes misleading statements to its employees.¹⁶⁹

Additionally, employees are likely to trust representations made by their employer.¹⁷⁰ Due to employees' predisposition to trust their employer, representations about the employer's stock will likely be taken at face value.¹⁷¹ Finally, people tend to comply with the wishes of authority figures.¹⁷² As employees are reliant upon their employer for their livelihood, employees have a large incentive to comply with their employer's wishes and recommendations. For these reasons, employees are more vulnerable than the general public to the employer's misrepresentations.

164. O'Hare, *supra* note 16, at 1224.

165. *Id.*

166. *Id.* at 1225.

167. *Id.*

168. *Id.*

169. *Id.*

170. O'Hare, *supra* note 16, at 1227.

171. *Id.* at 1225.

172. See STANLEY MILGRAM, OBEDIENCE TO AUTHORITY: AN EXPERIMENTAL VIEW 49-50 (1974) (describing the behaviors of a subject who believed that he was administering painful electrical shocks to another research participant).

B. *Employer Interests That Must Be Addressed*

1. *Cost Effectiveness*

Section 401(k) pension plans have become more popular among employers because these types of plans are less expensive to administer than traditional pension plans.¹⁷³ A 401(k) plan can be especially cost effective when the plan consists of the employer's stock.¹⁷⁴ For instance:

A corporation is allowed to deduct the full market value of stock that it contributes to the employees' 401(k) plan, even though the corporation's out-of-pocket cost is trivial or nonexistent. Furthermore, dividends paid on such stock are usually not deductible, but when these shares are held in a 401(k) plan, the dividends become a deductible expense.¹⁷⁵

Because a 401(k) plan's success is determined by the participant's ability to make sound investments, 401(k) plans can achieve maximum productivity from the workers with minimum financial contributions from the employers.¹⁷⁶

In light of the financial crisis this nation faces, a cost-effective pension plan is a particularly important consideration.¹⁷⁷ Recently, pension plans have suffered

173. See Kaplan, *supra* note 15, at 62-63.

There are several reasons for this shift from defined benefit plans to defined contribution plans, including (1) absence of [Pension Benefit Guaranty Corporation] premiums, (2) no actuarial expenses, (3) fewer compliance costs due to less burdensome regulations, and (4) the structural transformation of the American economy from unionized manufacturing companies to service sector operations and high technology enterprises.

Id. at 63. In light of the economic crisis, the ability to fund a pension plan with corporate stock instead of cash may be especially attractive. See, e.g., Eleanor Laise, *Despite Risks, Workers Guzzle Company Stock*, WALL ST. J., Mar. 5, 2009, at D1 ("In an effort to conserve cash, International Paper Co. this month began making 401(k) matching contributions in company stock rather than cash.").

174. See Kaplan, *supra* note 15, at 74 (stating that an employer can receive tax benefits when its employees' 401(k) plan is funded with the employer's stock). *But see* Benartzi et al., *supra* note 13, at 62 (arguing that in lieu of issuing stock directly to its employees, the employer could issue stock to the market, then use the capital raised to fund the pension plan). Additionally, many employers do not issue new stock to their employees; instead, employers tend to purchase stock from the open market and then subsequently issue the purchased stock to the employees. *Id.*

175. Kaplan, *supra* note 15, at 74.

176. See Schmall, *supra* note 11, at 932 (arguing that when a participant's pension investments underperform, the employer would receive a windfall, in that the employer has benefitted from optimal production, yet the employee has not received any monetary gain); see also Benartzi et al., *supra* note 13, at 66 (stating that there are three outcomes than can result from employees heavily investing in their employer's stock: (1) the employees could realize spectacular gains, (2) the employees could suffer spectacular losses, or (3) "participants take significant positions in their employers' stock, and their retirement savings are worth less than they seem (on average, 50 cents on the dollar) because of the inherently higher volatility of individual stocks").

177. See Mary Williams Walsh, *After Losses, Pensions Ask for a Change*, N.Y. TIMES, Nov. 20, 2008, at B1 (reporting that, due to the fact that many companies are currently facing a cash shortage, these companies are pushing for new laws that would lessen the amount of money that must be placed in pension funds).

staggering losses.¹⁷⁸ Any expenditure used to administer a pension plan would mean that the company would not have access to funds needed to stabilize the company.¹⁷⁹ For instance, if a company does not have enough cash on hand to pay its employees, it would have to institute layoffs. Laying off employees in order to maintain pension funds smacks of irony.

2. *Increased Motivation, Loyalty, and Benefits to the Corporate Directors*

Employee ownership of employer stock is most often justified as a way to increase employee motivation and productivity.¹⁸⁰ Additionally, employees who own shares of their employer's stock may be more likely to have a favorable view of management and may be more willing to go along with management's future plans for the company.¹⁸¹ A final consideration is that "additional purchases of the corporate employer's stock support that stock's market price."¹⁸² Higher stock prices benefit the corporation, and particularly the corporate directors, in several ways. First, high stock values can aid a corporation merging with another, since in certain circumstances, corporate stock is used to purchase the target company, or stock is sold to raise the capital needed to go forward with the merger.¹⁸³ Second, high stock prices add value to any stock options the corporate directors may hold.¹⁸⁴ Finally, high stock prices can provide job security to corporate directors, since high stock prices could make it more difficult for other corporations to acquire the company.¹⁸⁵ The more difficult it is for a company to be acquired, the less likely it is that the company will actually be acquired and its incumbent directors replaced.

In sum, there are three main problems with the existing 401(k) pension system: it allows for employees to over-invest in the employer's stock;¹⁸⁶

178. See *id.* ("The total value of company pension funds is thought to have fallen by more than \$250 billion since last winter.").

179. See *id.* ("[W]hen Congress tightened the pension rules it did not take this year's unprecedented market turmoil into account. If companies are now required to put new money into their pension funds, they say, they will not have the cash needed for business investments and payrolls.").

180. Benartzi et al., *supra* note 13, at 57. However, whether worker ownership of the employer's stock actually increases productivity is questionable. *Id.* According to what is called the "I/N problem," even if a low-level worker for a large corporation was to increase her productivity to reap the benefits of owning her employer's stock, the worker's efforts would have an extremely small effect on the employer's overall performance. *Id.* Additionally, there is little empirical evidence to support the proposition that worker ownership of the employer's stock increases productivity. *Id.*

181. See Kaplan, *supra* note 15, at 75 ("Giving employees a direct stake in the ownership of a business may align the interests of employees and company stockholders in other ways as well.").

182. *Id.* at 73.

183. *Id.* at 74.

184. *Id.* at 73.

185. See *id.* at 74 ("[H]aving employees hold portions of a company's stock provides a source of stockholder stability should some other company try to acquire it.").

186. See *supra* Part III.A.1 and accompanying text (discussing the fact that pension participants tend to over-invest in the employer's stock as part of their 401(k) plans).

employees generally lack the financial knowledge needed to manage their pension investments;¹⁸⁷ and employees are especially vulnerable to any misrepresentations their employer may make about its stock.¹⁸⁸ While 401(k) pensions must be reformed to address these issues, any offered reform must be cost effective¹⁸⁹ and must align the interests of both the participants and the company.¹⁹⁰ The proposals this Comment puts forward strike an appropriate balance by protecting 401(k) participants while avoiding excessive burdens upon employers.

IV. PROPOSED SOLUTIONS

A. *In Order to Qualify Under Section 401(k), a Pension Plan Must Have a Diversification Plan*

Employees, like the American public in general, suffer from a lack of financial education.¹⁹¹ Without a working understanding of finances or access to a financial planner, 401(k) participants will not receive optimal returns on their investments.¹⁹² If employees do not have faith in the soundness of 401(k) plans as retirement funds, employees may stop participating in these plans.¹⁹³

The Department of the Treasury has advocated reforming 401(k) pension plans by favoring “government policies [that] promote the ability of employees to make informed, educated decisions about how they wish to allocate their assets.”¹⁹⁴ One commentator has advocated that, as a condition for offering a defined contribution plan, employers must also offer employees individualized, independent financial advice.¹⁹⁵ Another commentator has proposed requiring employers to provide a “default” investment plan, which participants are free to change and which would be sufficiently diversified.¹⁹⁶ Although both proposals

187. See *supra* Part III.A.2 and accompanying text (discussing the public’s financial literacy).

188. See *supra* Part III.A.3 and accompanying text (discussing how representations made to employees via intra-office communications are not scrutinized by objective third parties).

189. See *supra* Part III.B.1 and accompanying text (discussing cost considerations that employers must account for when offering a pension plan).

190. See Part III.B.2 and accompanying text (discussing how 401(k) plans help to increase employee productivity).

191. Griffith, *supra* note 157; see also Financial Literacy Statistics, *supra* note 158.

192. Griffith, *supra* note 157.

193. Schmall, *supra* note 11, at 932; see also Lawrence, *supra* note 18, at 73 (“Transferring investment decisions and risks to participants who lack the financial acuity to make informed decisions is a recipe for disaster.”).

194. U.S. DEP’T OF THE TREASURY, REPORT OF THE DEPARTMENT OF THE TREASURY ON EMPLOYER STOCK IN 401(K) PLANS, at 7 (2002), available at [http://www.treas.gov/press/releases/reports/401\(k\).pdf](http://www.treas.gov/press/releases/reports/401(k).pdf).

195. Lawrence, *supra* note 18, at 73. Professor Lawrence reasons that individually tailored investment advice would give participants the ability to make sound investments, as well as help counteract any coercive influence an employer may exert over a participant’s investment decisions. *Id.*

196. Befort, *supra* note 19, at 981-82. Professor Befort argues that “[m]any participants are less-than-savvy investors who tend to think that company stock concentrations are a problem for others, but not

would be beneficial, it is important to note that pension plans are voluntarily provided by employers.¹⁹⁷ Therefore, Congress must strike the right balance of providing employee protections without deterring employers from offering pension plans.¹⁹⁸

This Comment argues that the best solution is to revise section 401(k) of the IRC to require qualified plans to contain a diversification component. This revision is in line with the common recommendations that an employee invest no more than ten percent of her pension into a single company¹⁹⁹ and that an investment portfolio consist of holdings from diverse classes of businesses.²⁰⁰ “[D]iversification across a number of asset classes ensures that a portfolio benefits from exposure to today’s outperforming asset classes while simultaneously reducing the downward drag on overall returns linked to asset classes that might underperform today, but could well outperform tomorrow.”²⁰¹ Taking these steps helps to ensure that a portfolio is insulated from the harms of market volatility, while maximizing the chances of showing strong returns.²⁰²

Adding a diversification requirement to section 401(k) would bring this provision in line with similar existing laws. For example, ERISA imposes a duty to diversify upon pension plan fiduciaries.²⁰³ This requirement recognizes that diversification “may protect against adverse business conditions, imprudence, or dishonesty in a particular field and minimize the risk of large losses.”²⁰⁴ Since 401(k) plans are meant to give participants control over their investment assets,²⁰⁵ it would be inappropriate to command participants to diversify their assets. However, pension plan fiduciaries are permitted to give investment advice to participants.²⁰⁶ It would not be a drastic measure for Congress to go a step further

themselves.” *Id.* at 980-81. Also, allowing employers to give participants investment advice may open the door for employers to act out of self-interest, instead of for the benefit of the participants. *See id.* at 981 (stating that allowing employers to give participants investment advice “runs counter to ERISA’s general prohibited transaction rules that bar parties with conflicts of interest from exercising fiduciary responsibilities”).

197. U.S. DEP’T OF THE TREASURY, *supra* note 194, at 1.

198. Lawrence, *supra* note 18, at 71.

199. O’Hare, *supra* note 16, at 1220.

200. *See Why Diversify, supra* note 163 (“Key to minimizing portfolio risk are discipline and diversification.”).

201. *Id.*; *see also* Note, *Fiduciary Standards and the Prudent Man Rule Under the Employment Retirement Income Security Act of 1974*, 88 HARV. L. REV. 960, 971 (1975) (“By then dividing his assets between [a high-risk, high-return] portfolio and a portfolio of risk-free investments, the investor can reach his desired level of risk for the entire portfolio.” (internal citation omitted)).

202. *Why Diversify, supra* note 163.

203. 29 U.S.C.A. § 1104(a)(1)(C) (West 1999).

204. Brock v. Citizens Bank of Clovis, No. Civ. 83-1054 BB, 1985 WL 71535, *2 (D.N.M. Dec. 20, 1985) (on file with the *McGeorge Law Review*).

205. *See* ERISA Section 404(c) Plans, 29 C.F.R. § 2550.404c-1(a)(1) (2008) (stating that ERISA’s fiduciary duties will be excused if “a participant or beneficiary is considered to have exercised independent control over the assets in his account”); *see also* Klaas, *supra* note 90, at 803 (stating that 401(k) plans were intended to allow participants to realize larger returns than the average defined benefit plan).

206. *See* 29 U.S.C.A. § 1108(g) (West Supp. 2008) (specifying the guidelines that must be followed in order to create an “eligible investment advice arrangement”).

and require that employers give some form of investment advice to 401(k) participants.

Furthermore, 401(k) plans receive substantial tax exemptions.²⁰⁷ Therefore, the American public has an interest in how 401(k) plans are governed.²⁰⁸ Rather than give employers nearly unbridled discretion as to how their 401(k) plan will operate, Congress should require that these plans be operated with a minimum level of emphasis put on prudent, careful investing. Reckless investing is one of the causes of the economic woes that plagued the United States in 2008.²⁰⁹ Rather than waiting until public funding is needed to keep an industry viable, Congress should enact proactive measures to ensure that extreme economic calamity does not completely decimate 401(k) plans.

Finally, 401(k) plans are attractive to employers because such pension plans are cost effective.²¹⁰ One may argue that modifying 401(k) pensions to mandate a particular type of diversification program may dissuade the employer from offering a pension plan, as the mandated diversification program may be a burdensome cost for a particular employer.²¹¹ Yet, there are currently stringent requirements regarding what constitutes a “qualified default investment alternative” for the purpose of automatic 401(k) investments.²¹² Furthermore, the law permits employers to charge employees for the investment advice provided.²¹³ In light of these facts, requiring 401(k) plans to contain a diversification component would not be unduly burdensome upon employers.

207. See 26 U.S.C.A. § 404(a)(3) (West 2002 & Supp. 2008) (describing the amount of tax deductions an employer can claim for contributing to a defined contribution account); see also *id.* § 402(a) (exempting funds placed in a 401(k) plan from taxation until the funds are distributed to the participant).

208. See Lawrence, *supra* note 18, at 47.

Given the fact that the federal government is providing billions of dollars in tax breaks to qualified retirement plan sponsors and participants, and that all Americans, including those that do not reap the benefits of qualified retirement plan coverage, are paying higher taxes to subsidize forgone revenues, federal tax policy discredits the argument that [defined contribution] plan assets belong solely to the respective participants and that investment decisions are their private financial decisions.

Id.; see also Kaplan, *supra* note 15, at 80 (“The public . . . has a major interest in the financial soundness of [tax-subsidized retirement plan] arrangements.”).

209. See 12 U.S.C.A. § 5211 (West Supp. 2009) (empowering the Secretary of Treasury “to make and fund commitments to purchase . . . troubled assets from any financial institution”). “Troubled assets” are defined as mortgages or any other “financial instrument[s]” that the Secretary of Treasury determines must be purchased in order to promote financial security. *Id.* § 5202(9).

210. See Kaplan, *supra* note 15, at 62-63 (stating that for several reasons, “including (1) absence of [Pension Benefit Guaranty Corporation] premiums, (2) no actuarial expenses, [and] (3) fewer compliance costs due to less burdensome regulations,” employers have come to favor defined contribution plans over defined benefit plans).

211. See *id.* at 63.

212. See Fiduciary Relief for Investments in Qualified Default Investment Alternatives, 29 C.F.R. § 2550.404c-5(e) (2008) (specifying the minimum requirements for a qualified default investment plan).

213. See 29 U.S.C.A. § 1108(g)(2)(A)(i) (West Supp. 2008) (defining an eligible investment advice arrangement as a plan that “provides that any fees (including any commission or other compensation) received by the fiduciary adviser for investment advice or with respect to the sale, holding, or acquisition of any security

1. Plans That Would Qualify Under the Diversification Component

There are three general approaches that would satisfy the diversification component. The first framework is a plan that would provide individualized investment advice to plan participants. This framework is similar to what Professor Janice Kay Lawrence has proposed.²¹⁴ According to Professor Lawrence's approach, "[p]ension reform must also include measures mandating employer-facilitated individually-tailored investment advice as a condition of ERISA Section 404(c) fiduciary liability relief."²¹⁵ Permissible variations of this framework may include regularly scheduled group investment seminars or providing participants with financial experts' contact information.

The second framework would provide a diversified default investment plan for all participants. Professor Stephen F. Befort has argued that requiring employers to provide a diversified default portfolio, which participants can modify if they choose to do so, would effectively nullify the participants' investment "inertia."²¹⁶ This framework should also allow for a plan in which the employer offers a variety of pre-determined investment plans with varying levels of risk.

The third type of framework that would satisfy the diversification component would be a plan in which the employer provides an incentive to participants to maintain diversified 401(k) portfolios. For example, under this framework, the employer may only provide matching contributions to employees meeting diversification standards. Somewhat similar to how ERISA provides tax incentives so advantageous that it would be irrational for a company not to comply with ERISA's provisions,²¹⁷ this framework would promote diversification by providing incentives that would make it irrational for a participant not to diversify her assets. The third framework, like the other two, would thus strike the appropriate balance between giving participants the autonomy to make their own investment choices and ensuring that the participants are making sound financial decisions.

2. Mechanics of a Diversification Component

The primary issue in establishing a diversification component is determining what would be needed in order to satisfy the requirement. It must be noted that

or other property for purposes of investment of plan assets do not vary depending on the basis of any investment option selected").

214. Lawrence, *supra* note 18, at 73.

215. *Id.*

216. Befort, *supra* note 19, at 981-82; *see also* James J. Choi et al., *Are Empowerment and Education Enough? Underdiversification in 401(k) Plans*, 2005 BROOKINGS PAPERS ON ECON. ACTIVITY 151, 154 (2005) (stating that 401(k) plans could be reformed by "giv[ing] firms incentives to adopt socially optimal default choices").

217. ROTHSTEIN & LIEBMAN, *supra* note 9, at 1162.

section 401(k) of the IRC tends to set flexible standards, supplemented with examples of plans that may meet those standards.²¹⁸ As the financial goals and needs of plan participants vary wildly, employers should be given a great deal of latitude to tailor their 401(k) plans to meet their employees' needs.²¹⁹

Existing law should be the touchstone for what is required to satisfy the diversification component. For instance, the Secretary of Labor has promulgated a regulation specifying what is required of a qualified default investment alternative.²²⁰ These specifications should be used to judge whether a default investment plan satisfies the diversification component. Similarly, an investment advice program must be based on a generally accepted computer model.²²¹ This requirement should be implemented to provide a basis for determining whether an employer's individual advice given to plan participants is based on sufficiently diversified recommendations.

Finally, the diversification component should not be viewed as a governmental edict on how participants must invest their 401(k) assets. Instead, participants should be able to deviate from the diversified plan as long as there is informed written consent.²²² Informed written consent is an important safeguard against fiduciaries not acting in the interest of the beneficiaries.²²³ Therefore, a participant should be allowed to deviate from the safety of the established diversification plan, so long as the participant is informed of and consents to the risks presented by the deviation.

218. See, e.g., 26 U.S.C.A. § 401(k)(11) (West 2002 & Supp. 2008) (describing a plan that would meet nondiscrimination requirements).

219. See Choi et al., *supra* note 216, at 154 (stating that it is difficult to establish universal 401(k) default investments, due to the fact that employees face a wide variety of economic circumstances); cf. Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) (reasoning that, because "judges are not business experts," it is inappropriate for courts to second-guess the business decisions made by a corporate board of directors).

220. Fiduciary Relief for Investments in Qualified Default Investment Alternatives, 29 C.F.R. § 2550.404c-5(e) (2008).

221. 29 U.S.C.A. § 1108(g)(3)(B) (West Supp. 2008).

222. See Befort, *supra* note 19, at 981-82 ("Employees could override the default option and change the investment mix to include company stock if it is offered by the plan as an investment option. Under this approach, employees could consciously choose to invest in company stock, but the impact of inertia, a definite force in determining investment allocations, would work in favor of diversification." (internal citations omitted)).

223. Cf. MODEL RULES OF PROF'L CONDUCT R. 1.8(a) (2008) (requiring that, before a lawyer can enter into a business transaction with her client, the lawyer must, inter alia, get the client's "informed consent, in a writing signed by the client, to the essential terms of the transaction"). Informed consent can include the lawyer having to explain to the client the material risks the client faces when entering into the business transaction. *Id.* at R. 1.8 cmt. 2. This rule recognizes that "[a] lawyer's legal skill and training, together with the relationship of trust and confidence between lawyer and client, create the possibility of overreaching when the lawyer participates in a business, property, or financial transaction with a client." *Id.* at R. 1.8 cmt. 1.

B. 401(k) Assets Should Not Include the Employer's Stock

Adding a diversification component to section 401(k) of the IRC is necessary in order to address the fact that many plan participants fail to adequately manage their 401(k) assets.²²⁴ Yet, this reform does not address the fact that plan participants tend to view their employer's stock as being a much better investment than it actually is.²²⁵ One group of researchers studied whether media coverage on the collapses of Enron, WorldCom, and Global Crossing would lead to 401(k) participants investing less heavily in their employer's stock.²²⁶ The researchers found that the media coverage resulted in little change in participants' investing strategies.²²⁷ In fact, the researchers found some evidence that the media coverage actually lead to participants investing *more* heavily in the employer's stock.²²⁸ Therefore, adding a diversification component is not a complete solution to the problems facing 401(k) participants—a second safeguard must be put in place.

The research on media coverage and investing strategies raises two issues: why do participants view their employer's stock in such an irrational manner, and what reforms are needed in order to ensure that participants do not over-invest in their employer's stock? As to the first issue, this Comment argues that participants hold an irrational view of their employer's stock because participants are unable to separate their role as an "employee" from their role as an "investor." To support this theory, this Comment focuses on the individual works of Stanley Milgram and Philip Zimbardo.

As to the second issue, this Comment argues that section 401(k) of the IRC should be amended so that the employer's stock cannot make up any portion of a 401(k) plan. At times, a participant's role as an "employee" can lead the participant to make decisions that are personally disadvantageous.²²⁹ Due to the danger that participants face when they include the employer's stock in 401(k) assets, and because psychological forces make it difficult for participants to handle the employer's stock in a financially responsible manner, an outright ban

224. See Befort, *supra* note 19, at 976 ("Many employees, faced with application forms and a dizzying array of investment options, simply procrastinate and do nothing. The complexity of the financial planning task, in other words, results in 'bounded rationality' and a sub-optimal process of retirement planning."); see also Choi et al., *supra* note 216, at 153-54 ("Households typically behave passively, following the path of least resistance.").

225. See Choi et al., *supra* note 216, at 192 ("[E]mpowering employees to trade out of employer stock and educating them about the risks of employer stock will have only a small effect on 401(k) employer stock holdings.").

226. *Id.* at 153.

227. *Id.* at 192-93.

228. *Id.* at 181-82.

229. See Andrew A. Luchak et al., *When Do Committed Employees Retire? The Effects of Organizational Commitment on Retirement Plans Under a Defined-Benefit Pension Plan*, 47 HUM. RES. MGMT. 581, 594 (2008) (finding that certain characteristics correlate with employees choosing to retire after it is most optimal to do so).

on allowing 401(k) plans to hold the employer's stock is needed. This ban serves as the additional safeguard that is needed to meet the diversification component's shortcomings.

1. Social Psychology Provides a Framework That Explains Why 401(k) Participants Overvalue Their Employer's Stock

Commentators have put forward several theories explaining why participants over-invest in their employer's stock.²³⁰ However, these theories seem to view plan participants as independent actors, while largely ignoring that situational forces also affect how participants operate. In other words, the fact that a plan participant is primarily an "employee" for the employer sponsoring the plan may cloud the participant's judgment when it comes to acting as an "investor."²³¹

Two classic psychological experiments demonstrate that situational forces can dramatically influence individual behavior. Stanley Milgram's obedience experiments studied the willingness of a person to harm another individual if someone in a position of authority instructed the person to do so.²³² An "experimenter" told the subjects that they would be participating in an experiment studying how punishment affects learning.²³³ The experiment's administrator instructed the subjects to read a series of word pairs to a "learner," to ask the learner to recall which words should be paired, and to administer an electric shock to the learner if he did not answer correctly.²³⁴ Subjects were told to increase the shock's intensity for each incorrect answer the learner gave.²³⁵ The intensity of the shock ranged from 15 to 450 volts.²³⁶

In reality, the "learner" was not actually receiving any electrical shock from the subject.²³⁷ The learner's role in Professor Milgram's experiments was to intentionally give wrong answers, then react to reflect the appropriate level of pain that would be expected from the shock intensity being administered.²³⁸ As the shocks increased in intensity, the learner would cry out in pain, insist that he

230. See, e.g., O'Hare, *supra* note 16, at 1221 (stating that employees may overinvest in their employer's stock, because an employee may view the employer's stock as a sound investment, out of loyalty, due to peer pressure, or because of encouragement from senior management).

231. Cf. Philip G. Zimbardo, *Revising the Stanford Prison Experiment: A Lesson in the Power of Situation*, CHRON. HIGHER EDUC., Mar. 30, 2007, at B6 (arguing that in the criminal justice context, situational forces should be used to explain a defendant's mens rea).

232. MILGRAM, *supra* note 172, at 13-14.

233. *Id.* at 17-18.

234. *Id.* at 19-21.

235. *Id.* at 20.

236. *Id.* (explaining that the "generator" had verbal markings indicating shock intensity as well, from "Slight Shock" to "XXX").

237. *Id.* at 24.

238. MILGRAM, *supra* note 172, at 22-23.

did not want to participate anymore, and eventually stop giving verbal feedback at all (as if to simulate that the learner passed out from the pain, or worse).²³⁹

Surveyed psychiatrists, college students, and laypersons all predicted that subjects would go no further than administering 300 volt shocks.²⁴⁰ These groups predicted that “only a pathological fringe” would be willing to administer a shock at full intensity.²⁴¹ Professor Milgram actually found that up to sixty-five percent of subjects, depending on the learner’s proximity to the subject, were willing to administer a 450-volt shock.²⁴²

The “Stanford Prison Experiment” provides an even more dramatic example of situational forces at work than Professor Milgram’s experiments, since the participants in the prison experiment acted without any sort of prompting from others.²⁴³ In the “Stanford Prison Experiment,” Philip Zimbardo attempted to study how behavior is affected when “good people” are put into an “evil situation.”²⁴⁴ Professor Zimbardo sought to recreate a prison setting within Stanford’s psychology department office by randomly dividing twenty-four student volunteers into two groups, guards and prisoners, with Zimbardo taking the role of the prison’s “superintendent.”²⁴⁵ To further add a sense of realism, the researchers gave the prisoners identity numbers and prison smocks.²⁴⁶

Professor Zimbardo intended for the experiment to last for two weeks.²⁴⁷ However, in a matter of days, the guards began to physically, verbally, and sexually abuse the prisoners.²⁴⁸ In turn, researchers had to release a number of prisoners due the fact that these participants began suffering from extreme stress.²⁴⁹ After just six days, the conditions of Stanford prison had become so deplorable that Zimbardo had to terminate the experiment.²⁵⁰

The work of Milgram and Zimbardo helps to demonstrate how situational forces can impact individual behavior.²⁵¹ Their work is significant within the context of 401(k) pension reform, because 401(k) participants have dual-roles:

239. *Id.* at 23.

240. *Id.* at 27-29.

241. *Id.* at 30-31.

242. *Id.* at 35-36.

243. S. Alexander Haslam & Stephen Reicher, *Beyond the Banality of Evil: Three Dynamics of an Interactionist Social Psychology of Tyranny*, 33 PERSONALITY & SOC. PSYCHOL. BULL. 615, 616 (2007).

244. Zimbardo, *supra* note 231.

245. *Id.*

246. *Id.*

247. *Id.*

248. *Id.*

249. *Id.*

250. *Id.* Interestingly, Professor Zimbardo became so engrossed in his role as prison “superintendent” that he initially lost sight of his duties as a psychological researcher. *Id.* It was not until the woman that Zimbardo was romantically involved with threatened to end their relationship that he came to his senses. *Id.*

251. See Haslam & Reicher, *supra* note 243, at 616 (discussing the impact of Professor Milgram’s and Professor Zimbardo’s work on the development of the “banality-of-evil” theory).

that of “employee” and that of “investor.”²⁵² For many individuals, the role of “employee” is central to their self-image.²⁵³ Moreover, people like to view themselves favorably and, thus as good employees.²⁵⁴

In light of these facts, it seems that when it comes to the employer’s stock, a 401(k) participant’s role as an “employee” overrides the participant’s role as “investor.” There is empirical evidence that suggests that a committed employee will ignore the tendency to act in her own self-interest.²⁵⁵ Thus, it seems that employees have difficulty separating what would be advantageous for them professionally from what would be advantageous personally. Employees tend to view the employer’s stock as being less risky than other investment types.²⁵⁶ While investing heavily in the employer’s stock would be irrational from the standpoint of an “investor,”²⁵⁷ it does make sense from the standpoint of an “employee”—i.e., organizational loyalty and commitment can be factors that would lead to an employee advancing within the organization. Additionally, since people tend to view themselves as good employees,²⁵⁸ and affective commitment is enhanced by an organization making its employees feel that their contributions are valued and important to the success of the organization,²⁵⁹ a person making investments from an “employee’s” perspective might over-estimate the actual value of the employer’s stock, since the employer’s success would reflect the employee’s abilities and contributions. Applying the preceding principles, the theory that 401(k) participants invest from an “employee” perspective may also explain why there was such a dramatic increase in participants investing in their employer’s stock during January 2009.²⁶⁰

Some may argue that employees do not recognize the risk of investing in their employer’s stock simply because of a lack of financial understanding.²⁶¹ Indeed, the American public does suffer from a general lack of financial literacy.²⁶² But, it is

252. Cf. *In re WorldCom, Inc. ERISA Litig.*, 263 F. Supp. 2d 745, 757 (S.D.N.Y. 2003) (noting that under ERISA, plan administrators wear “two hats”—that of an employer and that of a fiduciary).

253. DAVID G. MYERS, *EXPLORING PSYCHOLOGY* 131 (5th ed. 2002).

254. See MILGRAM, *supra* note 172, at 28-30 (explaining that people predicted that they would not disobey the researcher’s instructions to harm the learner because people want to view themselves as good).

255. See Luchak et al., *supra* note 229, at 594 (finding that a high level of affective commitment correlates with employees choosing to retire after it is most optimal to do so). “Affective commitment refers to an employee’s emotional attachment to, identification with, and involvement in the organization.” *Id.* at 585.

256. See Benartzi et al., *supra* note 13, at 54 (reporting that over sixty percent of respondents surveyed stated that they felt their employer’s stock was less than or just as risky as investing in a diversified stock fund).

257. *Id.* at 53 (stating that investing in the employer’s stock is especially risky, “because [employees] could lose their retirement funds and job at the same time”); Kaplan, *supra* note 15, at 78 (“The employee already has her livelihood and health insurance tied to the employer’s economic well-being. Any further alignment of the employee’s and the employer’s financial interests can only be described as reckless.”).

258. Cf. MILGRAM, *supra* note 172, at 28-30.

259. Luchak et al., *supra* note 229, at 585.

260. Laise, *supra* note 173 (reporting that 401(k) participants invested more than \$65 million in their employers’ stocks, despite the fact that these investors should be taking steps to diversify their holdings).

261. See Benartzi et al., *supra* note 13, at 53 (“[O]nly [six] percent of those with a high school education or less recognize the risk of [investing in] company stock.”).

262. Griffith, *supra* note 157; see also Financial Literacy Statistics, *supra* note 158.

unlikely that a lack of financial knowledge is the sole reason that employees choose to invest in their employer's stock. According to one study, education and the ability to diversify 401(k) assets would only have a slight effect on 401(k) participant decisions to invest in their employer's stock.²⁶³ Furthermore, empirical evidence exists that suggests a layperson can make financial decisions comparable to those a financial expert would make.²⁶⁴ Therefore, simply increasing a participant's financial knowledge would not solve the problem created when employees invest in their employer's stock.

In sum, situational forces seem to color how employees view investing in their employer's stock. Similar to how Zimbardo became so engrossed in his role as prison "superintendent" that he completely ignored his duties as a researcher,²⁶⁵ employees seem to lose their objectivity as "investors" when it comes to their employer's stock.²⁶⁶ The situational forces of an employment relationship are largely internal within the employee,²⁶⁷ so restrictions on managerial behavior would not necessarily have an impact on an employee's choice to invest in her employer's stock. Therefore, in order to ensure that 401(k) participants operate as "investors" and not as "employees," 401(k) plans should be forbidden from incorporating the employer's stock.

2. *Criticisms of Banning the Employer's Common Stock from the 401(k) Portfolio*

Some have argued that restrictions upon an employee's ability to invest in the employer's stock are overly paternalistic.²⁶⁸ One report from the U.S. Department of the Treasury trumpets that "[t]he nation's pension system has evolved in recent years into one that emphasizes two of the country's quintessential values: personal responsibility and freedom of choice."²⁶⁹ To this end, the Department of the Treasury reasoned that "[a]rbitrary caps on employees [sic] 401(k) investment choices challenge fundamental notions of private property rights. 401(k) participant contributions and matching contributions are a form of employee compensation, and government should not restrict or limit employees [sic] ability to invest their assets as they see fit."²⁷⁰ Yet, as previously

263. See Choi et al., *supra* note 216, at 192.

264. See Nada K. Kakabadse & Andrew Kakabadse, *Prudence vs. Professionalism: Exploratory Examination of Pension Trustee Capability*, 34 PERSONNEL REV. 567, 582 (2005) (finding that pension plan trustees without a background in finance can manage the plan at a level comparable to trustees with a background in finance).

265. Zimbardo, *supra* note 231.

266. See, e.g., Benartzi et al., *supra* note 13, at 53; see also Laise, *supra* note 173.

267. See MYERS, *supra* note 253, at 131 (stating that, for many individuals, their profession is important to their self-image).

268. Befort, *supra* note 19, at 980.

269. U.S. DEP'T OF THE TREASURY, *supra* note 194, at 1.

270. *Id.* at 7.

stated, commentators have noted that, since 401(k) plans receive tax subsidies, the American public has a stake in how these plans are administered.²⁷¹

Additionally, the paternalism argument presumes that participants do indeed have the freedom of choice. But, this viewpoint ignores the fact that situational forces play a role in determining individual behavior.²⁷² As this Comment argues, participants are unable to view their employer's stock in a rational manner.²⁷³ In light of the psychological conflicts between a participant acting as an "employee" and an "investor," it seems unrealistic to view the choice to invest in the employer's stock as a matter of "personal responsibility and freedom of choice."²⁷⁴

Some commentators have further criticized attempts to restrict an employer's ability to invest its stock into 401(k) plans on the grounds that the employer would be deterred from making matching contributions or from providing any pension fund at all.²⁷⁵ However, Professor Kaplan argues that it is unlikely that an employer would take these actions.²⁷⁶ Professor Kaplan notes that employers often offer matching contributions in order to increase employee participation.²⁷⁷ Broad employee participation benefits the employer's directors and officers, since it allows these individuals "to maximize their personal 401(k) plan deferrals."²⁷⁸ Furthermore, many employers may determine that a 401(k) plan would help attract productive, qualified workers to the corporation, so even if the employer's stock could not be offered as an investment plan, offering a pension plan would still be worthwhile.²⁷⁹

V. CONCLUSION

The past decade has demonstrated that no investment, no matter how sound it appears, is free of risk. For example, in August 2001, Enron stock was selling at ninety dollars per share.²⁸⁰ By January 2002, as a result of massive accounting fraud,²⁸¹ Enron stock traded at only thirty-six cents per share.²⁸² In another

271. See *supra* notes 207-08 and accompanying text (describing the argument that the American public has a stake in how these plans are managed, because employers receive tax incentives for pension plans).

272. See Zimbardo, *supra* note 231 (arguing that in the criminal justice context, situational forces should be used to explain a defendant's mens rea).

273. See *supra* Part IV.B.1 (describing how situational factors can impact individual behavior).

274. U.S. DEP'T OF THE TREASURY, *supra* note 194, at 2.

275. Befort, *supra* note 19, at 979; see also Lawrence, *supra* note 18, at 49 ("[O]pponents of overall limitations argue that employers are less likely to make employer contributions in the form of cash.").

276. Kaplan, *supra* note 15, at 79.

277. *Id.* at 79-80.

278. *Id.* at 80.

279. See Befort, *supra* note 19, at 947 (employers began using pension plans to attract and retain high-quality employees).

280. Reece, *supra* note 12, at 142.

281. See *id.* at 94 ("Thanks to insider Sherron Watkins, the world now knows that Enron hid billions of dollars in debts and operating losses inside private partnerships, with attractive names like 'Condor' and

example, a \$1,000 investment in Countrywide Financial made in 1982 would have been worth \$230,000 in 2003.²⁸³ Yet, in 2007, Countrywide needed a \$2 billion investment from Bank of America in order to continue to offer mortgages.²⁸⁴ Over a twelve-month period, General Motor's stock value declined by ninety percent.²⁸⁵ When Circuit City went out of business, it was the second-largest consumer electronics chain in the United States.²⁸⁶

Experts consider the financial crisis of 2009 to be the worst since the Great Depression.²⁸⁷ The result of the crisis is that 401(k) pension plans are in jeopardy, and this nation is at a crossroads in determining how to respond.²⁸⁸ Congress can institute safeguards that would help prevent pension plans from suffering the devastating effects of a Studebaker- or Enron-type collapse. On the other hand, Congress can wait to respond until after employees have already been harmed.²⁸⁹ Even absent specific Congressional action, society will still bear the burden of supporting employees affected by a pension fund collapse, since a portion these employees will likely be forced to seek public assistance.²⁹⁰

The 401(k) pension system is in desperate need of two reforms. First, there must be some sort of diversification component.²⁹¹ The bull market of the 1990s, during which everyone believed that investing in the stock market would guarantee a profit,²⁹² is now a distant memory. The large number of different companies affected by the economic crisis demonstrates the need for diversification.²⁹³ A diversified portfolio is the best defense against suffering

'Raptor.' The corrected financial statements reported a \$1,165,000,000 overstatement of earnings for the year 2000 alone." (internal citations omitted)).

282. Reece, *supra* note 12, at 146.

283. Shawn Tully, *Meet the 23,000% Stock for 20 Years, Countrywide Financial Has Been on a Tear; With the Housing Boom Winding Down, Can This Mortgage Star Keep From Falling?*, FORTUNE, Sept. 15, 2003, available at http://money.cnn.com/magazines/fortune/fortune_archive/2003/09/15/349151/index.htm.

284. *Wall Street, Still a Little Wobbly, Steadies Itself*, N.Y. TIMES, Aug. 25, 2007, at C2.

285. Laise, *supra* note 173.

286. Rosenbloom, *supra* note 6.

287. See Olive, *supra* note 7 ("As we rang in 2008, who guessed . . . that all the debt-financed spending by consumers and business over the past decade would someday culminate in the worst financial panic since the Dirty Thirties?").

288. See Powell & Zeleny, *supra* note 8 (reporting that then-Senator Barack Obama had called for more stringent regulations of the financial markets).

289. Cf. 12 U.S.C.A. § 5211 (West Supp. 2009) (empowering the Secretary of Treasury to purchase "troubled assets" in order to promote financial stability).

290. Kaplan, *supra* note 15, at 80.

291. See *supra* Part IV.A (discussing how a diversification component would rectify participants' general lack of financial knowledge).

292. Schmall, *supra* note 11, at 905-06.

293. Accord Rosenbloom, *supra* note 6 (discussing the retail chains that the financial crisis affected); Olive, *supra* note 7 (discussing the financial institutions that the financial crisis affected); see also Sommer, *supra* note 2 (reporting that Dow Jones industrial average fell twenty percent during the first two months of 2009).

large losses.²⁹⁴ Requiring that employers include a diversification component in order for their pension plans to qualify under section 401(k) would adequately guard against over-investment in a single employer.²⁹⁵ This requirement would also address the concern that most participants lack the financial knowledge needed to make sound investment choices.²⁹⁶ Because this diversification component would be a default rule, it does not take away participants' ability to make their own investment choices.²⁹⁷

Additionally, the law is beginning to recognize that situational forces can affect individual behavior.²⁹⁸ Situational forces should be examined in the employment context as well. Instead of viewing an employee's decision to invest in the employer's stock as a matter of personal choice, that action makes more sense when viewed in light of the larger employment context.²⁹⁹ The diversification component does not reach the fact that employees may hold an unreasonable view of the employer's stock. Therefore, in addition to adding the diversification component, the employer's stock should be banned from constituting a part of that employer's offered 401(k) plan. This second reform is necessary, not because participants *will not* view the employer's stock reasonably, but because participants *cannot* view the employer's stock reasonably.³⁰⁰

Financial security should not be reserved for the wealthy. As evidenced by ERISA and section 401 of the IRC, Congress would like for every working American to have a secure retirement. With modifications, 401(k) plans can be much more secure. Secure pension funds are essential, not only to plan beneficiaries, but to American society as a whole. The United States cannot afford to ignore this issue any longer.

294. See *Brock v. Citizens Bank of Clovis*, No. Civ. 83-1054 BB, 1985 WL 71535, *2 (D.N.M. Dec. 20, 1985) (on file with the *McGeorge Law Review*) (explaining the purpose for ERISA's duty to diversify).

295. See *supra* Part IV.A and accompanying text (discussing how a diversification requirement would help protect 401(k) participants).

296. *Id.*

297. See *supra* notes 222-23 (discussing how participants should be able to deviate from an employer's default investment with informed consent).

298. See *Zimbardo*, *supra* note 231 (arguing that in the criminal justice context, situational forces should be used to explain a defendant's mens rea).

299. See *supra* Part IV.B.1 (discussing how psychological forces affect how employees view the viability of their employer's stock).

300. See *supra* notes 261-64 and accompanying text (discussing how increased financial education alone is ineffective at addressing how employees view their employer's stock).