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Protecting Pension Annuities When Insurance Companies Fail: The ERISA Fiduciary Standards

James Epstein

NOTES

PROTECTING PENSION ANNUITIES WHEN INSURANCE COMPANIES FAIL: THE ERISA FIDUCIARY STANDARDS*

I. THE PROBLEM

In 1984, the Reagan administration decided to allow employers to terminate employee benefit plans[1] (pension plans) to free surplus pension funds for investment in the economy.[2] This occurred at a time

*Dedicated to Dr. and Mrs. Ake Epstein for their sacrifice and support.

1. The problem affects only defined benefit plans. The overwhelming majority of pension plans are defined benefit plans, which are to be distinguished from defined contribution plans. *See* Daniel Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105, 1112 (1988) (explaining the differences between defined contribution and defined benefit plans). Defined contribution plans are like savings accounts. *Id.* at 1112. The employee bears all of the investment risk and places into the plan as much money as the employee chooses. *Id.* With defined benefit plans, the employer bears all of the risk because the employer promises to pay a certain amount when the employee retires. *Id.* at 1112-13.

2. Steven Brostoff, *Metzenbaum: Feds, States Failed to Protect Pensions*, NAT'L UNDERWRITER: LIFE AND HEALTH, July 1, 1991, at 5. When a plan terminates, whatever surplus is left goes to the company in what is known as a "reversion." Until 1984, reversions were heavily taxed by the I.R.S. and permitted only when the surplus had been created by an actuarial mistake. *See* Neil Downing & Jeffrey L. Hiday, *Retirement: Is Your Money Safe?*, PROVIDENCE JOURNAL-BULLETIN, May 6, 1990, at F1 (detailing the evolution of the pension annuity problem). However, when stock prices began to boom in the early 80s, companies began to build tremendous surpluses and the Reagan administration ended the I.R.S. rules prohibiting reversions. *Id.* This allowed companies access to the surplus funds, after which they either created a new plan or sold the remaining pension assets into annuities. *Id. See also AFL-CIO Calls for Federal Remedy to Shield Retirees from Insolvencies*, 18 BNA PENSION REP. 1533 (Aug. 26, 1991) (detailing AFL-CIO argument that companies shopped for the cheapest annuities so that they could get more cash from the reversion and arguing that reversions are prohibited by ERISA) [hereinafter *AFL-CIO Calls for Federal Remedy*].

when the insurance industry was introducing new products which offered much higher interest rates than insurance products had ever offered in the past.[3] The newer products and higher interest rates were responses to competition from brokerages, mutual-fund companies and banks, all of which were able to begin paying money market rates in the early eighties.[4] Two of these products, tax-deferred, fixed rate annuities and guaranteed investment contracts (GICs),[5] became extremely popular choices for fiduciaries charged with investing pension funds.[6] The pension annuities became popular because they offered a high rate of return from an industry with a stable history and a conservative tradition of investing.[7]

However, starting in the mid to late eighties, the competition with other investment entities, and intense competition within the annuity industry itself, led insurance companies to become involved with junk bonds and to invest more heavily in real estate.[8] The recent collapse of these two markets, along with other economic factors, led to a "crisis" in the insurance industry.[9] Since the spring of 1991, two of the nation's largest insurers were taken over by state regulators, and twelve more were identified by the United States Department of Labor as being in danger of insolvency.[10] In 1991 state regulators had taken

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3. Anne Saker, *Changes in 80's Cause Heat in 90's*, U.S.A. TODAY, Oct. 8, 1991, at B1; *see also* Susan Pulliam & George Anders, *Mutual Benefit Life Took Plenty of Risks and Is Paying the Price*, WALL ST. J., July 26, 1991, at A1, col. 6 (stating that the whole insurance industry "plunged too deeply" into real estate).

4. Saker, *supra* note 3, at B1.

5. This note will refer to both products as "pension annuities."

6. Jane Bryant Quinn, *Is Your Pension Fund Safe?*, NEWSWEEK, Apr. 22, 1991, at 47. There are two types of tax deferred annuities. The simplest form gives regular payments for life beginning any time after age fifty-nine and a half, in return for a lump sum investment. *See* John Waggoner, *What You Get When You Buy . . .*, U.S.A. TODAY, Oct. 9, 1991, at B2 (describing new products insurance companies began offering in the early 80s). "Variable annuities," on the other hand, allow the investor to choose among several investment options and the return depends on how well the investments do. *Id.* GICs are very much like banks' certificates of deposit and pay a set rate for one to five years. *Id.*

7. *See* Saker, *supra* note 3, at B1 (stating that the insurance industry offered high rates with image of being secure financial institutions).

8. Pulliam & Anders, *supra* note 3, at A1, col. 6; *Are You Really Insured?*, BUS. WK., Aug. 5, 1991 at 43. At the end of 1990, insurers on average had 11.4% of their bond holdings in junk bonds, of which 19.6% was in higher risk, low quality junk bonds. Saker, *supra* note 3, at B1. Insurers had 24% of their money in real estate, of which 5% was in repossessed property or defaulted mortgages. *Id.* However, these percentages were much higher at the two largest companies that folded, Mutual Benefit Life and Executive Life. *Id.*

9. *Are You Really Insured?*, *supra* note 8, at 43.

10. Mayer Siegel & Carol Buckman, *Reform of Termination Insurance*, N.Y. L.J., Aug. 12, 1991, at 3.

over 34 insurers by October, compared with 32 in all of 1990 and 13 in all of 1988.[11]

The portfolios of the two largest insurance companies that failed in 1991, Executive Life of California and Mutual Benefit Life of New Jersey, both had large amounts of pension annuities.[12] Their well-publicized collapses created shock tremors through both the insurance and pension industries.[13] There were news stories about people losing their pensions, runs on other insurance companies, and calls for nationalization of the insurance industry from Capitol Hill.[14] The threat of more insolvencies seemed compelling when it was revealed that both companies had been rated highly by the top rating companies shortly before they collapsed.[15]

There was also an outcry from workers and labor advocates.[16] Indeed, holders of pension annuities offered by insolvent insurance companies may have more to fear than other consumers and creditors of insurance companies.[17] Pension annuity holders may suffer additionally from the fact that the federal government regulates pensions, while the states regulate the insurance industry.[18] Because of their dual nature, pension annuities fall into a grey area between state and federal regulation.

Because insurance regulation is left to the states,[19] when an insurance company fails, ideally, the company's consumers are paid off by

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11. Saker, *supra* note 3, at B2.

12. *Officials Defend Efforts to Protect Pensions Following Insurance Failures*, 18 BNA PENSION REP. 1280 (July 29, 1991) [hereinafter *Officials Defend Efforts*].

13. *See id.* (testimony at congressional hearings of represenatives from the insurance industry, the Labor Department and the Pension Benefit Guaranty Corporation (PBGC)).

14. *Nightline: Insurance Company Failures Hit Pension Funds* (A.B.C. television broadcast, July 18, 1991).

15. Eric N. Berg, *Insurers' Raters Are on the Spot for Inaccuracy*, N.Y. TIMES, Aug. 4, 1991, at 1, col. 2. The Mutual Benefit Life failure was more of a shock because it was "widely known" that Executive Life had invested heavily in junk bonds. *Id.* However, Mutual Benefit had limited its investments in junk bonds and was considered a "top line, conservative insurer, which appeared capable of meeting fiduciary obligations." *Officials Defend Efforts*, *supra* note 12, at 1; *see also* Siegel & Buckman, *supra* note 10, at 3 (describing Executive Life's high ratings).

16. *See AFL-CIO Calls for Federal Remedy*, *supra* note 2, at 1533 (reporting that the AFL-CIO urged congressional action to insure that workers whose employers purchased Executive Life annuities did not lose their pension benefits).

17. *See id.*

18. *See* Siegel & Buckman, *supra* note 10, at 3 (general description of the limits of federal and state regulation in the pension annuity context).

19. McCrarran-Ferguson Act, 15 U.S.C. §§ 1011-1015 (1988).

the state's guaranty fund.[20] However, all of the state guaranty funds are different, and, until recently, a few states did not even have guaranty funds.[21] Most states' funds do not cover GICs,[22] and those that provide for annuities only insure a limited amount.[23] Often, policy holders must wait a year or more to be paid.[24] Thus, depending on the individual's state of residence and whether the product is a GIC or an annuity, a holder of a pension annuity from a failed insurer will probably struggle to receive any portion of the money owed under the policy.[25]

In contrast, the federal government regulates pensions under Employee Retirement Income Security Act (ERISA).[26] The federal government also insures pensions through the Pension Benefit Guaranty Corporation (PBGC), the arm of the Labor Department that guarantees pensions.[27] However, when pension funds are sold into insurance annuities, the guarantee of the PBGC ceases.[28] Pension annuities, then, are strictly the province of state regulation, which offers only marginal protection.

Thus, under current regulation, the only viable relief for holders of pension annuities from failed insurance companies is an ERISA cause of action for breach of fiduciary duty against the fiduciary who originally purchased the annuities. One of the arguments against changing the current regulatory framework is that those who suffer from the primary flaw of state insurance regulation, gaps in the annuity and GIC coverage, have an ERISA remedy against employer-

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20. Quinn, *supra* note 6, at 47.

21. *Id.* New Jersey and Louisiana voted in 1991 to start guaranty funds. John Waggoner, *No Quick Fix for Policyholders*, U.S.A. TODAY, Oct. 9, 1991, at B2. Washington D.C. does not have a guaranty fund. *Id.* An individual is covered by the guaranty fund of the individual's home state, not the insurance company's. *Id.*

22. Waggoner, *supra* note 21, at B2.

23. *Id.*; *see Guaranteed Fund Coverage*, U.S.A. TODAY, Oct. 9, 1991, at B2 (detailing the extent of each state's guaranty fund coverage for each of the major insurance products).

24. Waggoner, *supra* note 21, at B2.

25. *See* Eric N. Berg, *Life Insurer Failures Point Up Flaws in Safety Nets of States*, N.Y. TIMES, June 24, 1991, at A1, col. 5 (detailing reasons critics say the state guaranty system is "woefully unprepared for a crisis of this magnitude"); Susan Pulliam, *Many Policyholders Have Little Protection If Insurers Go Bust*, WALL ST. J., May 22, 1991, at A1, col. 6 (reporting that depositors at banks, thrifts, and credit unions have more protection).

26. 29 U.S.C. §§ 1001-1461 (1988).

27. Quinn, *supra* note 6, at 47.

28. Brostoff, *supra* note 2, at 5; *see* Downing & Hiday, *supra* note 2, at F1 (quoting the Chairman of the PBGC stating, "Congress intended PBGC's insurance funds to be used only for plans that did not have sufficient assets . . . and not to provide for annuities directly.").

fiduciaries.[29] This note examines this ERISA remedy and identifies potential problems with the remedy's application in the pension annuity context. Next, this note discusses the three primary ERISA fiduciary duties to determine whether a fiduciary who has exchanged pension funds for annuities can always be held liable, and to suggest that courts may have some trouble applying these duties in the pension annuity context. These problems are certain to receive clarifying treatment from courts, since employees have recently filed two suits against employers who exchanged pension funds for Executive Life annuities.[30] Indeed, more suits will follow as the fallout zone from the insurance crisis widens.

II. THE ERISA FIDUCIARY PROVISIONS

Congress passed ERISA in 1974[31] in response to rampant abuse in the pension industry, including the loss of pensions due to fraud and mismanagement.[32] ERISA was designed to protect pension participants and their beneficiaries "by establishing standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans, and by providing appropriate remedies, sanctions, and ready access to the Federal courts."[33] The fiduciary standards of conduct are set out in the following section:

> 1104. Fiduciary Duties
> (a)(1) [A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—
> (A) For the exclusive purpose of:
> (i) providing benefits to participants and their beneficiaries; and
> (ii) defraying reasonable expenses of administering the plan;

29. *See Metzenbaum Developing Plan to Protect Pensioners from Annuity Payer's Failure*, BNA PENSIONS & BENEFITS DAILY, Sept. 17, 1991, at 1 (insurance industry spokesperson testifying to Congress, "We believe that ERISA's fiduciary standards are sufficient to ensure that participants and beneficiaries receive secure annuities. . . .") [hereinafter *Metzenbaum Developing Plan*].

30. *See* Siegel & Buckman, *supra* note 10, at 4 (reporting film of United States v. Pacific Lumber, N.D. Cal. No. 91-812 and United States v. Magnatek, E.D. Wis. No. 91-C-613).

31. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified as amended at 29 U.S.C. §§ 1001-1461 (1988)).

32. Nancy F. Bern, Note, *Fiduciary Responsibility: Prudent Investments Under ERISA*, 14 SUFFOLK U.L. REV. 1066, 1068 (1980).

33. 29 U.S.C. § 1001(b) (1988).

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying 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; and

(D) in accordance with the documents and instruments of the plan insofar as such documents and instruments are consistent with the provisions of this subchapter or subchapter III of this chapter.[34]

The ERISA fiduciary standards were modeled after the common law of trusts.[35] In fact, both the standards and the legislative history closely follow the *Restatement (Second) of Trusts*.[36] However, Congress modified what it borrowed from the *Restatement*.[37] Congress instructed that the fiduciary standards should only be applied in light of the "special nature and purposes of employee benefit plans."[38] Congress intended more flexibility than the common law rule had allowed, instructing that section 1104 should be interpreted in light of the size and scope of the plan.[39] At the same time, Congress wanted exacting

34. *Id.* § 1104(a).

35. Lewis G. Kearns, *Rules of Diversification Under ERISA*, 120 TR. & EST. 736 (1976). Common law prudence traces its origins to Harvard College v. Amory, 26 Mass. (9 Pick.) 446 (1830), which departed from the prior rule that prudence was measured by preservation of the corpus. *See* Bern, *supra* note 32, at 1070. *Harvard College* instructs that prudence is measured by analogizing to a prudent man, managing his own affairs. *Id.* at 1071. This standard required a balance between the prior emphasis, preservation of the trust, and supplying an income for the beneficiary. *See id.* at 1071-72.

36. Bern, *supra* note 32, at 1070-73.

37. *See* H.R. REP. NO. 533, 93d Cong., 1st Sess. 12 (1973), *reprinted in* 1974 U.S.C.C.A.N. 4639, 4651; Bern, *supra* note 32, at 1073 (Congress attempted to inject flexibility into the common law standard).

38. H.R. REP. NO. 533, *supra* note 37, at 4651.

39. *Id.*; *see* Morton Klevan, *Fiduciary Responsibility Under ERISA's Prudent Man Rule: What Are the Guide Posts?*, 44 J. TAX'N 152, 153 (1976) (Congress recognized the great diversity in employee benefit plans and expected the interpretation of § 1104 to vary with the size and skill of the fiduciary and the type of plan); *see also* Donovan v. Cunningham, 716 F.2d 1455, 1464 (5th Cir. 1983) (quoting H.R. CONF. REP. NO. 1280, 93d Cong., 2d Sess. 304 (1974), *reprinted in* 1974 U.S.C.C.A.N. 5038, 5084) ("Congress has exhorted those who must interpret and apply ERISA's fiduciary standards to do so 'bearing in mind the special nature and purpose of employee benefit plans.'")); Marshall v. Glass/Metal Ass'n, 507 F. Supp. 378, 383 (D. Haw. 1980) (§ 1104 establishes "uniform federal requirements to be interpreted both in the light of the common law of trusts, as well as with a view toward the special nature, purpose, and

standards that would offer beneficiaries maximum protection.[40] Thus, a distinct case law evolved from the ERISA fiduciary standards. Currently, in interpreting ERISA's fiduciary rules, courts refer to the common law of trusts, while aware of Congress's desire for more flexible, contextual analysis than the common law seemingly allowed.[41] The primary fiduciary duties created by ERISA are discussed briefly in the following paragraph.

Section 1104(a)(1)(A) is called the "exclusive benefit rule," and is ERISA's version of the common law duty of loyalty.[42] A fiduciary acting in the interest of any entity other than the plan and the plan participants violates the rule.[43] Section 1104(a)(1)(B) is ERISA's version of the prudent person standard of common law.[44] Again, Congress wanted more flexibility here than was available at common law.[45] Thus, Congress sculpted a modified version of the common law prudent person rule.[46] Instead of the common law prudent person "dealing in his own affairs,"[47] the ERISA fiduciary should use the care that a "prudent man acting in a like capacity . . . would use in the conduct of an enterprise of a like character."[48] The ERISA rule inspires more flexibility and specific factual analysis than the common law, but is still an objective test.[49] Section 1104(a)(1)(C) instructs a fiduciary to diversify the investment portfolio unless it is clearly prudent not to do so.[50] At common law, diversity was only one factor in determining whether a fiduciary had acted prudently.[51] The fact that Congress made it a separate requirement reflects the importance of diversity.[52]

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importance of modern employee benefit plans") (citing Marshall v. Teamsters Local 282 Fund, 458 F. Supp. 986, 990 & n.8 (E.D. N.Y. 1978)).

40. *See* Donovan v. Mazzola 716 F.2d 1226, 1231 (9th Cir. 1983) (citing Sinai Hosp. v. National Benefit Fund for Hosp. & Health Care Employees, 697 F.2d 562, 565 (4th Cir. 1982)) ("Courts have also recognized that in enacting ERISA Congress made more exacting the requirements of the common law of trusts relating to employee benefit trust funds.").

41. *See Marshall*, 507 F. Supp. at 383 (comparing ERISA diversity requirement with common law of trusts).

42. 29 U.S.C. § 1104(a)(1)(A) (1988); *see* Fischel & Langbein, *supra* note 1, at 1110.

43. Fischel & Langbein, *supra* note 1, at 1110.

44. 29 U.S.C. § 1104(a)(1)(B); *see* Bern, *supra* note 32, at 1073.

45. Bern, *supra* note 32, at 1073.

46. *Id.*

47. *Id.*

48. 29 U.S.C. § 1104(a)(1)(B) (1988).

49. Klevan, *supra* note 39, at 153.

50. 29 U.S.C. § 1104(a)(1)(C) (1988).

51. Bern, *supra* note 32, at 1075.

52. *Id.*

However, the requirement is not absolute. Congress noticeably refrained from proscribing any specific formula, and a fiduciary has a defense if the lack of diversity is "clearly prudent."[53] The next section of this note applies each of these ERISA duties to pension annuities and raises problems courts may have in applying those duties.

III. THE EXCLUSIVE BENEFIT RULE

ERISA's exclusive benefit rule, ERISA section 1104(a)(1)(A), states that a fiduciary "shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and — (A) for the exclusive purpose of (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan. . . ."[54] Section 1103(c)(1), "the noninurement rule," is another version of the exclusive benefit rule and states, "the assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purpose of providing benefits to participants in the plan and their beneficiaries."[55] The exclusive benefit rule is ERISA's embodiment of the duty of loyalty from the common law of trusts.[56] Congress intended the rule to remedy cases of self-dealing that were rampant throughout the pension industry before the passage of ERISA.[57] In these cases, the exclusive benefit rule, along with ERISA's remedial provisions, has proven to be "an effective corrective."[58]

In the pension annuity context, even without any other evidence of self dealing, the exclusive benefit rule would seem to prevent the initial creation of the annuities. This is because most employers terminate the original plan and exchange the pension funds for annuities to obtain surplus funds which were generated through the investments of the original plan.[59] The first step in the termination procedure is

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53. H.R. CONF. REP. NO. 1280, *supra* note 39, at 5084.

54. 29 U.S.C. § 1104(a)(1) (1988).

55. *Id.* § 1103(c)(1); *see id.* § 1106 (enumerating prohibited transactions and incorporating the exclusive benefit rule); Fischel & Langbein, *supra* note 1, at 1108-09 (discussing ERISA's exclusive benefit rule).

56. *See* RESTATEMENT (SECOND) OF TRUSTS § 170(1) (1957) (The trustee shall "administer the trust solely in the interest of the beneficiary.").

57. Fischel & Langbein, *supra* note 1, at 1110.

58. *Id.*; *see also* Donovan v. Mazzola, 716 F.2d 1226 (1983) (exclusive benefit rule violated when trustees of plan lent plan funds to a convalescent fund of which they were also trustees).

59. *See supra* note 1; *see also* Fischel & Langbein, *supra* note 1, at 1151 ("Beginning in 1982, the runup in the stock and bond markets caused pension plan assets to experience a huge increase in value. The number of overfunded plans burgeoned, and so did the number of termi-

that the employer figures all of the liabilities of the plan.[60] Then, if there are surplus funds, the employer terminates the plan, takes the surplus in what is known as a "reversion," and uses the balance (what the plan owes out in liabilities) to purchase the annuities.[61]

At first glance, terminations of pension plans followed by reversions of surplus assets seem to violate the exclusive benefit rule.[62] The employer-fiduciary enters into a transaction with plan assets to increase the wealth of the company by receiving the surplus funds. The transaction certainly is not performed for the "exclusive purpose of providing benefits to participants and their beneficiaries."[63]

However, terminations followed by reversions of surplus assets are legal under other sections of ERISA, which effectively create an exception to the exclusive benefit rule. ERISA sections 1341-1344 detail the procedures for plan termination.[64] Section 1344(d)(1) promulgates three requirements for reversion: all liabilities of the plan must be satisfied, the plan itself must provide for reversion, and the reversion must otherwise be legal.[65] A Treasury Department regulation[66] provides one more criteria: the surplus must be attributable to a mistaken actuarial assumption, which most often is that the expected costs of plan operation exceed actual costs.[67] Thus, other sections of ERISA make the reversion of surplus assets legal, even though the reversions seemingly violate the exclusive benefit rule.[68] Without some other evidence of self dealing or dual loyalty by an employer-fiduciary, the exclusive benefit rule is not a major factor in the pension annuity context.

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nations whose purpose was to recapture the reversion for the employer."). *But see Extending PBGC Protection to Annuities Would Raise Problems, GAO Official Says*, 18 BNA PENSION REP. 784 (May 6, 1991) (stating that sometimes plans are terminated for reasons other than recovery of excess assets and sometimes annuities are purchased for reasons other than plan termination).

60. *See* Fischel & Langbein, *supra* note 1, at 1150-53 (explaining the process and ramifications of asset reversion).

61. *Id.*

62. *Id.*

63. 29 U.S.C. § 1104(a)(1)(A)(i) (1988).

64. *Id.* §§ 1341-1344.

65. *Id.* § 1344(d)(1).

66. 26 C.F.R. § 1.401-2(b)(1) (1991).

67. Jennifer L. Pratt, Note, *Reversion of Surplus Assets Upon Plan Termination: Is It Consistent with the Purpose of ERISA?*, 62 IND. L.J. 805, 810 (1987) (detailing the policy arguments against allowing reversions of surplus plan assets).

68. *See generally id.*

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IV. THE DIVERSITY RULE

ERISA section 1104(a)(1)(C) states that a fiduciary shall 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."[69] The burden is first on the plaintiff to prove a lack of diversity and then shifts to the defendant to prove that the lack of diversity was prudent under the circumstances.[70]

The diversity rule initially appears to be the most obvious source of liability for a fiduciary in the pension annuity context. The fact that Congress included a separate, affirmative duty to diversify, instead of leaving diversity as a sub-category of the prudent person standard, is an indication of the importance that Congress attached to the requirement.[71] However, since the passage of ERISA in 1974, it remains unclear just how much diversity is required and whether prudence is a defense even in cases of a complete lack of diversity.

This question is crucial in light of the recent crisis in the insurance industry and its effect on pension annuities.[72] When an entire pension plan is traded for insurance annuities, technically, the plan's assets are not diversified at all.[73] The entire pension portfolio is composed of annuity contracts, all from a single insurance company.[74] Thus, if a purely technical or percentage analysis of diversity is required under ERISA, the fiduciary breaches its obligation in the pension annuity scenario.[75]

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69. 29 U.S.C. § 1104(a)(1)(C) (1988).

70. H.R. CONF. REP. NO. 1280, *supra* note 39, at 5084.

71. Bern, *supra* note 32, at 1070.

72. *See supra* text accompanying notes 8-11.

73. *See* Jones v. O'Higgins, No. 87-CV-1002, 1989 U.S. Dist. LEXIS 10537 (N.D. N.Y. Sept. 1, 1989) (where the defendant-fiduciary concentrated all of the pension assets into three high-risk stocks, the least technical diversity that has been allowed, the *Jones* court held that even though the plan lacked technical diversity, the defendant's investment strategy was prudent under the circumstances); *see also infra* text accompanying notes 101-09 (explaining *Jones* in detail).

74. *See* Quinn, *supra* note 6, at 47 (describing the transfer of pension funds to annuity contracts). *But see* Jerry Geisel, *Employers Seek to Limit GIC Losses: Executive Life Fiasco May Hit 401K Plans*, BUS. INS., May 13, 1991, at 3 (indicating that sometimes only part of the fund is invested in annuities).

75. If courts make the first level of analysis, technical diversity, determinative, a pension annuity defendant does not have a chance. Some courts appear to do this, implying that when diversity falls below a certain floor the diversity rule has been breached. *See* Whitfield v. Tomasso, 682 F. Supp. 1287, 1301 (E.D. N.Y. 1988) (concentrating between 25% and 89% of assets into one type of investment breached the diversity rule); Sandoval v. Simmons, 622 F. Supp. 1174, 1211-12 (D.C. Ill. 1985) (investing 18.5% in one type of investment, 11% in another,

However, Congress explicitly declined to set a specific ceiling or percentage amount to indicate diversity under ERISA. Congress wanted a more flexible rule which would require a fiduciary and the courts to consider the facts and circumstances of a particular case.[76] Thus, the fiduciary has a defense if the lack of diversity was prudent "under the circumstances."[77] This emphasis is also reflected in the "guiding factors" for determining diversity contained in the congressional conference report for ERISA: (1) the purpose of the plan; (2) the amount of plan assets; (3) financial and industrial conditions; (4) the type of investment; (5) the plan documents; (6) geographic and industrial distribution; and (7) dates of maturity.[78]

The last four factors are more susceptible to mechanical, bright line application than the others.[79] One commentator interpreted number (4), "the type of investment," as recommending simply that the fiduciary seek more than one type of investment.[80] Number (5) makes plan documents a factor, even though ERISA treats violations of plan documents under a separate, implied strict liability provision.[81] Number (6) recommends geographic and industrial distribution. Number (7), "the dates of maturity," is a "routine element in selecting a portfolio of maturing or callable senior securities, such as bonds, debentures, notes, or preferred stocks."[82]

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and 14% in another did not breach the diversity rule). *But see* Brock v. Citizens' Bank of Clovis, 841 F.2d 344, 346 (10th Cir. 1988) (concentrating 65% of the assets in first mortgages constituted only a preliminary breach, after which defendant was not able to show that the lack of diversity was prudent).

76. H.R. CONF. REP. NO. 1280, *supra* note 39, at 5084-85; *see* Note, *Fiduciary Standards and the Prudent Man Rule Under the Employee Retirement Income Security Act of 1974*, 88 HARV. L. REV. 960, 966-68 (1975) (arguing that pension plan fiduciaries should get more flexibility than provided by the common law of trusts because of differences between conventional trusts and pensions).

77. H.R. CONF. REP. NO. 1280, *supra* note 39, at 5084.

78. *Id.*

79. Kearns, *supra* note 35, at 736-37.

80. *See id.*

81. *See* 29 U.S.C. § 1104(a)(1)(D) (1988). This section instructs a fiduciary to act in accordance with the plan documents and functions as an implied strict liability provision. *See* Bern, *supra* note 32, at 1076 n.84 (citing Knickerbocker, *Federal Fiduciary Standards*, *in* G. MUNCH, FEDERAL TAXATION OF INSURED PENSIONS § 22.03(2), at 50 (T. Spencer & P. Walker, rev. ed. 1976)). A fiduciary who violates the instructions of plan documents will always be liable under ERISA. *See id.* at 1065 & n.84. However, the plan documents can serve as a defense for fiduciaries as well. Arkakelian v. National W. Ins. Co., 755 F. Supp. 1080, 1082-84 (D.D.C. 1990). In the pension annuity context, a fiduciary who is accused of breaching the diversity requirement by investing all of the pension funds into insurance annuities does not violate ERISA if the plan documents instruct the fiduciary to purchase the annuities. *Id.* at 1083-84.

82. Kearns, *supra* note 35, at 736-37.

Congress intended much of the analysis under the ERISA fiduciary standards to focus on whether the fiduciary's behavior was prudent under the facts and circumstances of the case.[83] However, the last four guiding factors do not offer the fiduciary many contextual prudence arguments in the pension annuity context. Fiduciaries battling charges of violating the diversity requirement probably did not seek more than one type of investment and did not distribute industrially or geographically.

The other three guiding factors, however, inspire more contextual analysis and open up potential arguments of prudence for the fiduciary.[84] Thus, under number (2), "amount of plan assets," a smaller plan may be much more difficult to diversify, and not seem to present much risk of large loss when invested in a large insurance company.[85] Also, under number (3), "financial and industrial conditions," the fiduciary can argue that annuities from a top rated insurance company seemed like the safest alternative, particularly with the volatile economy of the late eighties and early nineties[86], and the stable history of the insurance industry.[87]

Likewise, under number (1), "purpose of the plan," the fiduciary can argue that annuity contracts seemed like the most prudent vehicles to satisfy the purpose of the plan. Most pension plans are defined benefit plans.[88] Their purpose is to "produce a guaranteed specified pension for participants. This requires using funding media which in amount and type will produce the required funds."[89] Thus, fiduciaries are required to insure that the plan pays out what it originally promised the participants, usually in the form of a monthly payment very much like an annuity payment.[90] This requires the fiduciary to invest

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83. *See id.*

84. *Id.*

85. *Id.* at 738; *see* RESTATEMENT (SECOND) OF TRUSTS § 227 (1957) (indicating that it may be proper to concentrate all of a very small trust in a single investment); *see also* Klevan, *supra* note 39, at 152-53 (arguing that Congress intended the prudence determination to depend on the size of the plan or the employer).

86. Louis S. Richman, *Who Is Nick Brady? Why It Matters*, FORTUNE, May 22, 1989, at 60 (this is an era of "huge budget and trade deficits, volatile interest and exchange rates, and skittish global financial markets").

87. *See* RESTATEMENT (SECOND) OF TRUSTS § 227 (1957) ("So also, in times of crisis and general financial instability, it may be proper to invest a large portion or even the whole trust estate in a single type of security."); Saker, *supra* note 3, at B1-B2 (stating that the industry offered high interest rates and the image of being financially secure).

88. *See* Fischel & Langbein, *supra* note 1, at 1112.

89. Kearns, *supra* note 35, at 737.

90. *Cf. id.* (noting that a typical pension plan may guarantee a joint and survivor annuity in the form of monthly payments).

the pension funds to insure that there will be enough to pay all that the pension originally promised.[91]

Insurance annuity contracts appear to be a perfect investment, especially in a volatile economy, because the contracts themselves promise to fulfill the "purpose of the plan," that is, paying each participant the amount promised under the plan.[92] This is true even if the insurance company invests the particular pension funds in such a way that the insurance company loses money.[93] An insurance company, unlike many employers and fiduciaries, has a diversified pool of general assets with which to pay out the contracts, even if those particular contracts lost money for the insurer.[94]

Thus, annuity contracts seem like prudent investments that fulfill the purpose of the plan. By getting insurance companies, who themselves have extensive, highly diversified assets,[95] and a history of stability and safety,[96] to promise to fulfill the "purpose of the plan," the fiduciary has taken substantial steps to "minimize the risk of large losses."[97] Otherwise, in more conventional investing procedure, when a plan loses money through the investments of the fiduciary, the fiduciary makes up the difference.[98] However, the fiduciary may be unable to cover such losses, especially if it is a small employer without extensive capital or other resources. Thus, a compelling prudence argument is offered when it reasonably appears to the employer-fiduciary that an insurance company is in a better position to fulfill

91. *See id.*

92. *See* Waggoner, *supra* note 6, at A11 (stating that GICs and annuities promise a set rate of return).

93. *See* Stephen H. Goldberg & Melvin S. Altman, *The Case for the Nonapplication of ERISA to Insurers' General Account Assets*, 21 TORT & INS. L.J. 475, 480-81 (1985) (describing insurers' general accounts and arguing against extending ERISA fiduciary standards to insurers' administration of these accounts).

94. *See id.* at 478.

95. *See id.*

96. *See* Eric N. Berg, *New Ratings a Milestone for Insurers*, N.Y. TIMES, July 22, 1991, at D1, col. 6 ("Until recently, virtually all of the big insurance companies had been considered rock solid — their ability to pay claims beyond question."); *Are You Really Insured?*, *supra* note 8, at 43 (stating that "life insurance has long seemed a potent and benevolent force in society, . . ." and "policies were grounded in a bedrock of solid investments"); Downing & Hiday, *supra* note 2, at F1 ("Annuities used to hold the reputation of stodgy, but dependable investments.").

97. 29 U.S.C. § 1104(a)(1)(C) (1988).

98. *See* Kearns, *supra* note 35, at 737 (analyzing the apparent ERISA intent that when a loss occurs and the beneficiary is not paid what the plan promised, then the fiduciary can be sued).

the purpose of the plan by paying on annuity contracts.[99] The employer-fiduciary, on the other hand, may reasonably appear to be less able to cover losses or diversify investments.[100]

Using a similar, contextual analysis regarding the prudence defense, the United States District Court for the Northern District of New York in a 1989 case, *Jones v. O'Higgins*,[101] held that an investment advisor who invested all of the plan assets into only three high risk stocks did not breach the diversity requirement.[102] The court relied on testimony of the defendant investment advisor and his expert to find that the defendant acted prudently even without diversity.[103] This was because the defendant's "contrarian" investment philosophy was known to the trustee plaintiff and was acknowledged by expert testimony as reasonable, relatively common and credible within the investment industry.[104]

Defendant and defendant's expert witness testified that the philosophy involved finding under-valued stocks of a few companies, putting most or all of the assets of the plan into the stocks, and then holding the stocks and probably incurring some short term losses until the stock rebounded.[105] When the plan lost around $500,000, the trustee plaintiff withdrew the remaining assets and sued the defendant.[106]

The *Jones* court accepted defendant's argument that under contraianism it was necessary to hold onto the stocks until they rebounded to make large profits, that if there were too much diversity the strategy would not generate substantial profits, that the plaintiff knew this, and that if the plaintiff had not withdrawn the funds prematurely the plan would have made a large profit.[107] The court also relied heavily on the expert testimony that defendant's behavior was reasonable by industry standards.[108] Thus, even though the investments were not diversified, they were "clearly prudent" under the circumstances.[109]

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99. *See generally* Klevan, *supra* note 39, at 152-53 (stating that Congress apparently intended prudence determination to depend on size and skill of fiduciary).

100. *Id.*

101. No. 87-CV-1002, 1989 U.S. Dist LEXIS 10537 (N.D. N.Y. Sept. 1, 1989).

102. *Id.* at *21.

103. *Id.*

104. *Id.*

105. *Id.* at *5-6.

106. *Id.* at *8.

107. *Id.* at *18-22.

108. *Id.* at *21.

109. *Id.* at *22.

The analysis used by the court in *Jones* was of the type intended by Congress when it passed ERISA and is consistent with the guiding factors of the committee reports.[110] The court first found a prima facie lack of diversity, and shifted the burden to the defendant.[111] The court then used a contextual analysis to find that the defendant had acted prudently.[112] In doing so, the court noted prevalent industry standards in finding that the defendant's strategy, even given the lack of diversity, called for the plan to achieve its purpose.[113]

In the pension annuity context, the prudence defense used by the defendant in *Jones* will cause problems for courts, especially in the context of smaller employers who invest in highly rated insurance companies. Such employers have strong prudence arguments, especially under industry standards and financial and industrial conditions. Employers can argue that investment in pension annuities was, under the financial and industrial conditions at the time, a prudent way to attempt to achieve the pension plan's purpose. Employers also can argue that purchasing pension annuities from highly rated insurance companies was reasonable under industry standards. These arguments may be enough to counter a plaintiff's initial showing of a lack of diversity and relieve the defendant of liability under the diversity requirement.

V. THE PRUDENT PERSON RULE

ERISA section 1104(a)(1)(B) requires a fiduciary to act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[114] Like the diversity rule, the prudent person standard was derived from the common law of trusts, but with Congress' instruction that the requirement be interpreted in light of "the special nature and purposes of employee benefit plans."[115] Also like the diversity rule, there was concern shortly after ERISA's pas-

110. *See* H.R. CONF. REP. NO. 1280, *supra* note 39, at 5084-85.

111. *Jones*, 1989 U.S. Dist. LEXIS 10537, at *17.

112. *Id.* at *17-25; *see supra* text accompanying notes 101-09.

113. *Jones*, 1989 U.S. Dist. LEXIS 10537, at *17-25; *see supra* text accompanying notes 101-09.

114. 29 U.S.C. § 1104(a)(1)(B) (1988).

115. H.R. REP. NO. 533, *supra* note 37, at 4650; *see also* Klevan, *supra* note 39, at 153 (explaining that Congress wanted to take into account the great diversity in the administration of employee benefit plans).

sage that the new prudence rule would retain too much of the common law's inflexibility.[116] Over time an objective test evolved, focusing on whether the fiduciary "(1) employed proper methods to investigate, evaluate, and structure the investment, (2) acted in a manner as would others who have a capacity and familiarity with such matters, and (3) exercised independent judgement when making investment decisions."[117]

Courts' emphasis in applying the test appears to be on the first prong, often phrasing the prudence rule as the "duty to investigate" or "monitor."[118] The other prongs tend to help courts define and clarify what is adequate monitoring or investigation. Consequently, some courts clarify the duty to investigate and monitor by emphasizing that the investigation or monitoring be independent, as required under the third prong.[119] Thus, one court stated, "[a] fiduciary's independent investigation of the merits of a particular investment is at the heart of the prudent person standard."[120]

Other courts emphasize the second prong and examine whether the investigation or monitoring was done in a manner consistent with that done by others in like capacity.[121] Often, this analysis is accomplished through an evaluation of industry standards. The court in *Jones*, for example, found the defendant's contrarian investment practices prudent because they were "within the standards and practice in the investment industry."[122] The plaintiff in *Jones* argued that by allowing the value of the plan to lose $500,000 in nine months, the defendant had breached his duty to monitor the investments.[123] When the plan began to lose money, the plaintiff argued, the defendant should have switched investments.[124]

In response, the court emphasized that to find the defendant liable, the plaintiff would have to prove the defendant "acted imprudently

116. *See* Bern, *supra* note 32, at 1073 n.56 (describing the legislative hearings in which the Nixon administration rejected the common law rule as "too inflexible and undiscerning of the vast diversity in pension plans").

117. *Jones*, 1989 U.S. Dist. LEXIS 10537, at *22.

118. *See* Donovan v. Cunningham, 716 F.2d 1455, 1467 (5th Cir. 1983) ("[c]ourts have focused the inquiry under the 'prudent man rule' on a review of the fiduciary's independent investigation of the merits of a particular investment").

119. *Id.*

120. Fink v. National Sav. & Trust Co., 772 F.2d 951, 957 (D.C. Cir. 1985).

121. *See, e.g.*, Marshall v. Glass/Metal Ass'n, 507 F. Supp. 378, 384 (D. Haw. 1980).

122. *Jones*, 1989 U.S. Dist. LEXIS 10537, at *24.

123. *Id.* at *23.

124. *Id.*

within the standards of the investment industry."[125] Instead, the defendant introduced evidence that his contrarian investment strategy was reasonable by investment industry standards.[126] Evidence introduced by the plaintiff that the plan's assets were "severely diminished," by itself, was not enough.[127]

To define industry standards, the relevant industry must be identified. In *Jones*, that determination was easy.[128] Because the fiduciary was an investment counselor, the investment industry was used.[129] However, in the typical pension annuity case, the fiduciary is the employer, not an outside investment counselor.[130] Therefore, the relevant industry would not have the high level of investment expertise of the investment industry.[131] ERISA's legislative history rejects the idea that the statute requires the fiduciary to be a prudent expert with professional investment skills.[132] Instead, "the expertise required of the fiduciary will vary with the size and scope of the plan."[133] Thus, the relevant analysis in the pension annuity context should focus on other employers of comparable size who sell their pension funds into insurance annuities where the parent insurance companies of those annuities have remained completely healthy.

A large and easily discernible model exists. In 1983, there were 32.4 million Americans covered by pension plans funded through life insurance companies.[134] Reserves held by these companies to support contractual obligations to private pension plans amounted to $264.6

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125. *Id.* at *24.

126. *Id.* at *23.

127. *Id.* at *24.

128. *Id.* at *5.

129. *Id.* at *21-22.

130. The focus is almost entirely on employers as the fiduciaries in the pension annuity context. Thus, one argument in support of reforming ERISA or nationalizing the insurance industry is that by the time participants stop receiving their pension annuity benefits, there may not be an employer around to sue under ERISA. *See Metzenbaum Developing Plan, supra* note 29, at 1.

131. *See* Klevan, *supra* note 39, at 153.

132. Bern, *supra* note 32, at 1075; *see* Klevan, *supra* note 39, at 153 (stating that only banks, trust companies, investment advisors, and the like are required to be prudent experts, while others are held to a less rigorous standard).

133. Bern, *supra* note 32, at 1075. *But see* Jane Applegate, *Leave Management of the Pension Plans to the Professionals*, WASH. POST, Nov. 25, 1991, at 11, col. 3 (ERISA requires that plan trustees must "not only act in a prudent manner but also manage the fund as an expert would.").

134. Goldberg & Altman, *supra* note 93, at 482 (citing AMERICAN COUNCIL OF LIFE INSURANCE, PENSION FACTS (1985)).

billion.[135] Thus, a relevant model for the industry standards used in cases like *Jones* can be easily ascertained in the pension annuity context and would be the many pension-annuity consumers who appear to have made prudent decisions. Thus, if a particular fiduciary did not independently investigate or monitor an insurance company as compared to other employers who sold their pension funds into annuities, that fiduciary would breach the prudent man rule.

Although there are no cases applying the duties to investigate and monitor in the pension annuity context, an analogous situation is presented when an employer entrusts the assets of a plan to an investment company or advisor. In that situation, the employer is subject to the ERISA fiduciary standards and must investigate or monitor the investment company or advisor.[136] Thus, the United States District Court for the Southern District of New York in a 1988 case, *Whitfield v. Cohen*,[137] held that a fiduciary violated the duty to investigate because the fiduciary failed to investigate any aspect of an investment company.[138] The fiduciary had turned over the assets of a pension plan to the investment company, which subsequently caused the plan to lose over $600,000 (the original investment of over $280,000 plus opportunity cost).[139]

However, after the fiduciary is held liable for failure to investigate, the *Whitfield* court emphasized that it "must then examine whether, considering the facts that an adequate and thorough investigation would have revealed, the investment was objectively imprudent."[140] The *Whitfield* court held that there was no evidence to show that even if the fiduciary had prudently investigated, he could have discovered the problems with the investment company.[141]

The *Whitfield* court went on to state, however, that the fiduciary also had a duty to monitor after the initial investment decision.[142] The court found that the fiduciary had not attempted to monitor the investment company.[143] The court also found that there was evidence to

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135. Goldberg & Altman, *supra* note 93, at 482.

136. 29 U.S.C. § 1002(21)(A) (1988) (stating that a person is a fiduciary "to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such a plan or exercises any authority or control respecting management or disposition of its assets.)"

137. 682 F. Supp. 188 (S.D. N.Y. 1988).

138. *Id.* at 195.

139. *Id.* at 193.

140. *Id.* at 195.

141. *Id.* at 196.

142. *Id.*

143. *Id.*

show that if the fiduciary had properly monitored the activities of the investment company, he would have been alerted to the many problems with it, and been able to withdraw the plan assets and prevent a large loss.[144] Thus, for a fiduciary to breach the prudence rule, a court must determine that adequate investigation or monitoring would have revealed the problems with the investments.

The *Whitfield* court relied on a 1984 decision of the United States Court of Appeals for the Second Circuit, *Katsaros v. Cody*.[145] In *Katsaros*, the fiduciaries made a two million dollar loan of pension assets to a bank which was subsequently closed by state and federal regulators.[146] The security for the loan was stock of the bank.[147] None of the fiduciaries had any expertise or experience to judge whether the bank was healthy or whether the loan was a sound one.[148] They simply relied on the information supplied by the bank.[149]

The defendant-fiduciaries in *Katsaros* argued that they made a reasonable investigation given their lack of knowledge of the banking industry.[150] The *Katsaros* court held that the defendants had failed to conduct a reasonable investigation, which would have revealed that the loans were unwise.[151] The court went on to say that the defendants, even with their lack of knowledge, could have fulfilled the duty to investigate by seeking outside assistance from an expert.[152]

Thus, *Jones* instructs that the investigation and monitoring must be reasonable by industry standards.[153] *Whitfield* states that the duties to investigate and monitor are analyzed on two levels: whether the duties were actually fulfilled and if not, whether they could have been fulfilled.[154] *Katsaros* instructs that non-experts can fulfill the duties to investigate and monitor by seeking outside assistance from experts.[155]

It is difficult to predict how this law will be applied in the pension annuity context, where the most obvious "experts" fulfilling the re-

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144. *Id.* at 197.
145. 744 F.2d 270 (2d Cir. 1984).
146. *Id.* at 275-76.
147. *Id.* at 275.
148. *Id.*
149. *Id.*
150. *Id.* at 279.
151. *Id.* at 279-80.
152. *Id.* at 279.
153. *See supra* text accompanying notes 122-27.
154. *Whitfield*, 682 F. Supp. at 195.
155. *Katsaros*, 744 F.2d at 279.

quirements of *Katsaros* are the insurance rating companies.[156] Rating companies are commonly used to evaluate the health of insurers both by private individuals and institutional investors.[157] Thus, if an insurer had a bad rating from a rating company, it would be difficult for a defendant to argue prudence. Because rating companies are so widely used by anyone who is even remotely involved in the insurance industry, referring to one before purchasing an insurance product is an obviously prudent alternative.

However, in both the Mutual Benefit Life and Executive Life failures, the insurers were highly rated by the top rating companies up until shortly before they failed.[158] Thus, the question is whether checking with the rating company, by itself, satisfies the requirement to investigate and monitor. The resolution of the question will depend on the facts of the case and, to a great extent, the timing of it.

Before 1991, there was no insurance "crisis" and most thought that there was only a remote chance of losing an investment in the insurance industry.[159] Most thought that the insurance companies that failed were smaller insurers that probably did not have high ratings anyway.[160] The specter of large insurance companies with high ratings failing probably seemed inconceivable.[161] Thus, prudent investigation and monitoring, consistent with common practice and available infor-

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156. *See Writing, Dialing for Ratings*, U.S.A. TODAY, Oct. 9, 1991, at B2 (listing the rating companies).

157. Berg, *supra* note 15, at 1, col. 2 ("Many people frequently check them to see whether their pension money, savings plans or life insurance policies are safe."); Berg, *supra* note 96, at D1, col. 6 (downgrading of six major insurance companies may prompt pension trustees to withdraw funds from those companies); *How Safe a Bet Is Your Insurer?*, U.S.A. TODAY, Oct. 9, 1991, at B2 ("For most people, the best way to evaluate an insurer is to rely on the professional ratings services.").

158. Berg, *supra* note 15, at 1; Siegel & Buckmann, *supra* note 10, at 4. Executive Life seemingly represents a blatant failure on the part of the rating companies because knowledge of Executive Life's questionable junk bond holdings was "widespread." *Id.* On the other hand, Mutual Benefit Life had a sterling reputation before it failed. *See Officials Defend Efforts*, *supra* note 12, at 1280 (asserting that Mutual Benefit Life "was considered a top line, conservative insurer").

159. *See supra* note 96; *see also* Richard S. Teitelbaum, *How Safe Is Your Insurance?*, FORTUNE, Sept. 9, 1991, at 138 (reporting that an Executive Life annuitant stated, "I knew the history of the industry. . . . No life insurance company large enough to operate across state lines had ever been allowed to fail.").

160. *See Moody's Anticipates Further Downward Adjustment of U.S. Life Insurers*, BNA PENSIONS & BENEFITS DAILY, Oct. 2, 1991, at 1 (reporting that Executive Life was "dismissed as an aberration" because of its reputation as an "upstart" company).

161. *See supra* note 96.

mation about the insurance industry, may have been to simply check the ratings.[162]

However, now, after the well-publicized insolvencies of Mutual Benefit Life and Executive Life and the failure of the rating companies to spot the problems, prudent investigation may consist of something more than checking the ratings. One result of the recent failures is that the ratings companies themselves have changed.[163] They are reforming the way they analyze insurance companies and focusing more on the amount of junk bond and risky real estate holdings that insurers possess.[164] Consequently, after the Executive Life and Mutual Benefit Life failures, some other insurers were downgraded by the rating companies.[165] Thus, ratings, while not foolproof, now appear to more accurately reflect insurer health than they did before the Executive Life and Mutual Benefit Life failures.[166]

Even given the recent reform of rating companies' evaluative procedures, some argue that it is relatively easy to take additional steps in investigating insurers.[167] These steps include checking whether the insurer uses independent actuaries, the insurer's reputation in the market place, asset quality, ability to withstand a run (liquidity) and history with state regulators.[168] Also instructive is the state where the insurer is registered, because some states offer more protection and have a better reputation for insurance regulation than others.[169]

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162. *See* Berg, *supra* note 96, at D1, col. 6 (quoting an insurance executive recommending that, even in light of the recent crisis, adequate investigation is satisfied by simply checking the ratings — but only insurers receiving the very highest ratings should be considered).

163. *See* Berg, *supra* note 15, at 1 (detailing the changes made after the Executive and Mutual Benefit Life failures and the criticism that the rating companies have an inherent conflict of interest because their primary customers are the insurance companies themselves).

164. *Id.*; *see also Assessing Insurer Ratings*, BUS. INS., Aug. 12, 1991, at 8 (rating companies seem to be "refining their rating procedures").

165. Berg, *supra* note 96, at D1, col. 6; *see also Moody's Anticipates Further Downward Adjustment of Some U.S. Insurers*, *supra* note 160, at 1 ("Moody's Investors Service expects further downward adjustments on of its ratings of some U.S. life insurance firms.").

166. *See Assessing Insurer Ratings*, *supra* note 164, at 8 (although they have improved their procedures, rating companies have the same problem that state regulators do: relying on "financial statements that are months old."); Berg, *supra* note 15 (quoting an insurance executive who recommended only dealing with insurers which receive the highest rating possible).

167. *Assessing Insurer Ratings*, *supra* note 164, at 8.

168. *Id.*; *see also* Teitelbaum, *supra* note 159 (compute liquidity by the ratio of capital to surplus using information supplied in the insurer's annual report).

169. *See How Secure Is Your Nest Egg?*, FORTUNE, Aug. 12, 1991, at 51; *see also Guaranteed Fund Coverage*, USA TODAY, Oct. 9, 1991, at A11 (detailing the guaranty fund coverage of each state); Teitelbaum, *supra* note 159, at 138 (describing New York as a leader in insurance regulation).

Likewise, the contractual terms of the annuity purchased are important. Thus, in light of the recent publicity, it may be imprudent to purchase an annuity with a high cancellation or surrender fee, because the fiduciary should be aware of the risk of insurer failure.[170] On the other hand, such terms in annuities purchased before the recent publicity could be a defense by a fiduciary charged with violating the duty to monitor by not canceling the annuities. Often, even after an insurer has been taken over by state regulators, it is imprudent to cancel or transfer the annuities because of high penalties.[171]

All of the above steps can be performed relatively cheaply, without hiring an outside expert. Also, they probably would have revealed the problems with Executive Life where, even though it was rated highly, many knew of its heavy investments in risky junk bonds.[172] However, because the economic conditions on which insurers' investments rely can change so quickly, sometimes it may be virtually impossible to foresee insurer failure.[173] The Mutual Benefit Life failure caught almost all by surprise.[174] In the end, much as Congress intended, the prudence question will be determined by the facts of the case. However, even if industry practice and common knowledge dictated otherwise before 1991, it is now clear that something more than checking the ratings is required in prudently investigating and monitoring insurers. How much more will depend on the facts of the case, but the practical effect of the recent "insurance crisis" will probably lead courts to require that fiduciary-employers monitor and investigate insurance companies much more thoroughly then they did before.[175]

VI. CONCLUSION

The primary factor in determining a breach of both the diversity and prudent person rules is the prudence idea derived from common

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170. *Assessing Insurer Ratings*, *supra* note 164, at 8. The major rating services have not always accurately forecast the future solvency of insurance companies. *Id.*

171. Teitelbaum, *supra* note 159, at 138 (switching insurers may not be worth the expense).

172. Siegel & Buckmann, *supra* note 10, at 4.

173. *Assessing Insurer Ratings*, *supra* note 164, at 8; *see* Berg, *supra* note 15, at 1 ("No ratings agency could have predicted that panicked policyholders would flock to cash in their policies. Nor could the agencies have predicted that regulators would seize companies still afloat. . . . A major part of the problem . . . is that insurance companies are far more complex than they were a decade ago" because of new, more complex products and the newly volatile real estate market).

174. *Officials Defend Efforts*, *supra* note 12, at 1281.

175. *Moody's Anticipates Further Downward Adjustment of Some U.S. Life Insurers*, *supra* note 160, at 1.

law.[176] For diversity, prudence is a defense when investments are not diversified and is usually measured by the seven "guiding factors," most notably plan purpose and economic and industrial conditions.[177] Economic and industrial conditions, as well as independent evaluation, also affect the determination of a breach under the prudent person rule.[178] While the common law prudence standard allowed for some flexibility,[179] Congress intended to derive even more flexibility from both the diversity and prudent person determinations under ERISA.[180] Thus, in the pension annuity context, defendant-fiduciaries who invest in pension annuities from a highly reputed and rated company like Mutual Benefit Life will have strong prudence arguments under the diversity and prudence rules. However, those same prudence arguments will lose their effectiveness if the annuities are purchased after the recent publicity of the "insurance crisis." The industry has lost its reputation of stability and conservatism and a prudent fiduciary now should investigate a company thoroughly before purchasing pension annuities.

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176. *See supra* text accompanying notes 69-109, 114-52.

177. *See supra* text accompanying notes 74-109.

178. *See supra* text accompanying notes 114-52.

179. Bern, *supra* note 32, at 1073 (stating that the original flexible rule of Harvard College v. Amory, 26 Mass. (9 Pick.) 446 (1830), has been narrowed through the years).

180. *See supra* text accompanying notes 35-39.