ERISA AND THE LIMITS OF EQUITY

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I
INTRODUCTION

As we approach the third decade of the Employee Retirement Income Security Act ("ERISA")[1] era, to what extent is it fair to say that ERISA is a statute that sounds in equity? What difference does the answer make in terms of the statute's success in reforming the delivery of employee benefits?

If we confine our consideration of the first question to the language and history of the statute, the answer is straightforward: Congress borrowed heavily from equity. ERISA section 403[2] requires that assets of employee benefit plans be held in trust. Sections 404, 405, and 406[3] impose equity-based fiduciary duties on persons exercising control of plan assets or discretionary control of plan management, and section 409[4] creates liability for breach of such duties. Section 502[5] authorizes participants, beneficiaries, fiduciaries, and the Department of Labor to bring civil suits to obtain equitable relief appropriate to enforce the provisions of the legislation and of employee benefit plans.

Measuring the actual impact of ERISA's debt to equity on the delivery of employee benefit plans is considerably more problematic. ERISA's version of equity includes a rule of prudence and a rule requiring plan fiduciaries to discharge their obligations for the sole purpose of providing benefits to participants and their beneficiaries (the "exclusive purpose rule").[6] Such rules have failed to provide a satisfactory, or at least complete, framework for resolving basic and recurring statutory issues.[7] For example, may a pension plan accept a reduced rate of return in favor of investments that create employment opportunities for participants? May a court award punitive damages to a participant wrongfully denied benefits? What standard should courts use in reviewing a denial of benefits? Such questions raise straightforward policy issues

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1. Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001-1461 (1988).
2. *Id.* § 1103(a).
3. *Id.* §§ 1104-1106.
4. *Id.* § 1109.
5. *Id.* § 1132.
6. *Id.* § 1104.
7. Daniel Fischel and John Langbein have earlier argued that ERISA's exclusive purpose rule "misdescribes the reality of the modern pension and employee benefit trust." Daniel Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105, 1107 (1988). Their seminal article suggests that Congress seized upon the wrong standards for judging fiduciary behavior, that it should have explicitly recognized the employer interest in employee benefit plans, and that it should have adopted the trust duty of impartiality to mediate between disputes among employees.

concerning the delivery of employee benefits. Yet ERISA pushes courts into responding to such questions by applying rules developed under equity, shunting into the background issues of benefits policy.

In its attempt to control dishonest behavior, ERISA adopted not only the exclusive purpose rule mentioned above, but also a series of specific rules prohibiting transactions between a plan and parties with preexisting relationships with the plan. These rules reflect principles that equity birthed and nurtured to prevent self-dealing on the part of trustees. In theory, ERISA's exclusive purpose and prohibited transaction rules, because of their great breadth, should serve prophylactically, keeping plan fiduciaries out of even the peripheral zone of self-interested conduct. Experience with the statute suggests, however, that the shape of the standards used to restrain self-interested behavior may be less important than effective monitoring of such behavior; some actors will ignore even exacting standards if they believe there is little risk of apprehension.

On the whole, then, my conclusions about the effects of ERISA's version of equity on the delivery of employee benefits are not particularly sanguine.[8] Nevertheless, employee plans are entities in which some people hold and control money for the benefit of others. As a result, principles derived from equity are relevant to any discussion about employee plans. At the same time, these principles cannot furnish thoroughly considered answers to questions concerning benefits policy. Complete answers must take account of considerations such as the governmental interest in ensuring the efficient use of the tax subsidies for health and retirement plans, the inherently contractual nature of the benefit promise,[9] and protection of both the nation's elderly and workers.

Part II of this article describes, for background purposes, the structure of ERISA's provisions related to fiduciary conduct, revealing a fairly high degree of legislative piety to equity, particularly the law of trusts. Part III, using three unresolved benefits issues as examples, argues that rules drawn from equity have not satisfactorily resolved basic issues of benefits policy. Part IV suggests that use of equitable principles are a necessary, but insufficient, measure to curb dishonest fiduciary behavior.

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8. This does not mean that ERISA is failed legislation; it means only that ERISA is not perfect. ERISA is a complex statute that forever changed the legal landscape of employee benefit plans. For example, ERISA's creation of federal vesting standards for pension plans, *see* I.R.C. § 411; ERISA § 203, 29 U.S.C. § 1053, has had a pronounced effect on the benefit contract. ERISA introduced dollar limits on benefits for the affluent, thereby limiting the tax-sheltering possibilities of pension plans for the highly compensated. *See* I.R.C. § 415. ERISA also introduced minimum funding standards. *See* I.R.C. § 412; ERISA § 302, 29 U.S.C. § 1082. ERISA created a federal program insuring benefits in defined benefit plans. *Id.* §§ 4001-4002, 29 U.S.C. §§ 1301-1461. Although subject to criticism, see, e.g., Richard Ippolito, *Pension Security: Has ERISA Had Any Effect?*, 2 Regulation 15-20 (No. 2, 1987), reprinted in PENSION AND EMPLOYEE BENEFIT LAW (John Langbein & Bruce Wolk, eds., 1990), this program has provided important protection for worker expectations that they will be paid their benefits. Moreover, the introduction of meaningful federal regulation of pensions and other employee benefits in itself was an important idea, one that might be built on in the future.

9. *But see* Jay Conison, *Foundations of the Common Law of Plans*, 41 DEPAUL L. REV. 575 (1992) (arguing that contractual framework poorly fits benefit policy issues).

The article concludes that Congress should revisit basic issues of benefits policy for which judicial reliance on equity has not furnished fully considered answers. The conclusion, though, suggests that such issues may be almost as hard to tame legislatively as they have been judicially. The problem is that the overarching policy decision to furnish retirement and health benefits through the private employment market rests uneasily on competing notions: government regulation is necessary to ensure that private law adequately delivers benefits, but too much regulation diminishes the willingness of employers to sponsor plans at all. If this tension is intractable, direct government provision of health and retirement benefits may ultimately replace the current voluntary private system.

II

THE RELATIONSHIP BETWEEN ERISA AND EQUITY

ERISA is a multifaceted statute, but, arguably, at its core are the standards of conduct it establishes for those entrusted with the administration of employee benefit plans. The relationship between plan officials and plan participants is heavily laden with fiduciary aspects: the former manage plan assets for the purpose of providing benefits to the latter. It is hardly surprising, then, that Congress settled on equity, and particularly trust law, as the appropriate framework for regulating the conduct of plan fiduciaries.

A. Trust Law as a Framework for ERISA

1. *The Legislative History of ERISA's Fiduciary Standards.* As an initial matter, one must consider why Congress decided to federalize rules of conduct for plan administrators. Most plans—at least pension plans—were set up as trusts, even before ERISA, and thus were subject to state trust law.[10] The legislative history of ERISA identified three problems with relying on state trust law to provide standards for fiduciary conduct.[11]

First, the assets of some pre-ERISA plans were managed by insurance companies: thus, no trust existed. Second, state trust law, committed as it is to effectuating settlor intent, allowed settlors to modify and even eschew trust principles as part of the trust indenture. Third, the trust law of the different states failed to provide a uniform set of rules governing fiduciary behavior, which was increasingly desirable given the interstate nature of many retirement plans.

ERISA's legislative history indicates that Congress intended to adopt "principles of fiduciary conduct . . . from existing trust law, but with modifications appropriate for employee benefit plans."[12] At the plan level, ERISA

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10. *See generally* Note, *Pension Plans and the Rights of Retired Workers*, 70 COLUM. L. REV. 909, 922 (1970).

11. *See, e.g.*, H.R REP. NO. 93-533, 93d Cong., 1st Sess. 11-12 (1973), *reprinted in* 2 LEGISLATIVE HISTORY OF THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974, at 2358-59 (1976) [hereinafter LEGISLATIVE HISTORY OF ERISA]; S. REP. NO. 93-127, 93d Cong., 1st Sess. 29 (1976), *reprinted in* LEGISLATIVE HISTORY OF ERISA, *supra*, at 615.

12. H.R. REP. NO. 93-533, *supra* note ?1, at 13, *reprinted in* 2 LEGISLATIVE HISTORY OF ERISA at 2360.

section 403(a)[13] requires that employee benefit plan assets be held in trust, with certain limited exceptions.[14] Moreover, ERISA's substantive fiduciary provisions apply to all plans, even those that the statute exempts from the trust form.[15]

At the individual level, ERISA has broadly defined the persons and entities subject to its substantive fiduciary requirements. The statute classifies such persons as "fiduciaries," which it defines as persons or entities who exercise discretionary authority or discretionary control respecting management or disposition of plan assets; those who render investment advice for a fee; or those who have discretionary authority or discretionary responsibility in the administration of the plan.[16] The definition of fiduciary is broad, and the courts and the Department of Labor have interpreted the term with moderate liberality. For example, a corporate board member becomes a fiduciary if the board is charged with appointing a plan trustee.[17] ERISA's substantive fiduciary rules, however, apply to plan fiduciaries only to the extent they perform fiduciary functions.[18]

2. *ERISA's Substantive Fiduciary Standards.* ERISA's legislative history indicates that its fiduciary section "in essence, codifies and makes applicable to . . . fiduciaries certain principles developed in the evolution of the law of trusts."[19] ERISA effects this codification with two related sets of fiduciary standards: the first is a series of general trust principles;[20] and the second is a list of specifically proscribed activities.[21]

The general trust principles provide that a plan fiduciary must discharge his or her duties solely in the interests of the plan's participants, act prudently (the "prudent man rule"), diversify plan investments, and act in accordance with plan

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13. 29 U.S.C. § 1103(a).

14. The most important of these exceptions is for plans whose assets consist of insurance contracts. ERISA § 403(b)(1), 29 U.S.C. § 1103(b)(1).

15. *Id.* § 401(a), 29 U.S.C. § 1101(a) provides that ERISA's fiduciary standards apply to employee benefit plans with only limited exceptions. The exceptions include governmental plans, church plans, and certain plans providing benefits for highly compensated employees.

16. *Id.* § 3(21), 29 U.S.C. 1002(21).

17. 29 C.F.R. § 2509 (1990) (providing that board members are fiduciaries to the extent they perform fiduciary duties, including appointment of other plan fiduciaries); Leigh v. Engle, 727 F.2d 113, 133 (7th Cir. 1984) (directors "performed fiduciary functions in selecting and retaining plan administrators"); United States Steel Corp. v. Pennsylvania Human Relations Commission, 669 F.2d 124 (3d Cir. 1982). While the term "fiduciary" is broad, it is not all-encompassing. It does not, for example, ordinarily reach individuals who provide accounting, legal, or arbitration services to a plan. *See, e.g.*, Anoka Orthopaedic Assoc. v. Lechner, 910 F.2d 514 (8th Cir. 1990); Brown v. Roth, 729 F. Supp. 391 (D.N.J. 1990); DOL Adv. Op. 79-66(A) (Sept. 14, 1979). Moreover, an employer does not, by virtue of designing and adopting a plan, become a fiduciary. *See, e.g.*, Letter from Department of Labor to John Erlenborn (Mar. 13, 1986), *reprinted in* 13 Pens. Rep. (BNA) 472 (1986) [hereinafter Erlenborn Letter]; United Independent Flight Officers v. United Air Lines, 756 F.2d 1274 (7th Cir. 1985).

18. *See, e.g.*, Erlenborn Letter, *supra* note 17; Brandt v. Grounds, 687 F.2d 895 (7th Cir. 1982) (bank's fiduciary responsibility limited to investment advice). All fiduciaries, however, are liable for breaches of co-fiduciaries if they had knowledge of the breach and failed to take steps to remedy it. ERISA § 405(a)(3), 29 U.S.C. § 1105(a)(3). *See also* Department of Labor Interpretive Bulletin, 29 C.F.R. § 2509 75-5 (1975).

19. H.R. REP. NO. 93-533, *supra* note 11, *reprinted in* 2 LEGISLATIVE HISTORY OF ERISA at 2358.

20. ERISA § 402(a), 29 U.S.C. § 1102(a).

21. *Id.* § 406, 29 U.S.C. § 1106.

instruments.[22] The statute's legislative history indicates an expectation "that courts will interpret the prudent man rule and other fiduciary standards bearing in mind the special nature and purposes of employee benefit plans intended to be effectuated by the Act."[23]

The second set of standards is a more particularized set of prohibitions against fiduciaries doing any of the following: causing the plan to enter into transactions with parties already related to the plan ("party-in-interest prohibitions"),[24] using plan assets for the fiduciary's own account,[25] or acting on behalf of a party or receiving compensation from such party with respect to a transaction involving the plan.[26] The "party-in-interest" transactional prohibitions are broad and explicit, proscribing dealings with all "parties in interest," a term encompassing most individuals and entities with preexisting relations with the plan.[27] ERISA includes statutory exemptions from the prohibited transaction rules and establishes a procedure in which the Department of Labor can create further exemptions administratively.[28]

The trust law concepts from which ERISA's fiduciary duties are derived and their ERISA counterparts may be contrasted in the context of specific fiduciary duties imposed upon plan administrators.

First, both ERISA and trust law impose a duty of loyalty on plan and trust administrators. The common law of trusts imposes an unyielding duty on trustees to administer the trust in the sole interest of the beneficiaries. This duty proscribes self-dealing of any sort on the part of the trustee.[29] The principle obviously reaches situations in which the trustee has in fact overreached, but it also applies to transactions that are substantively fair to the trust at the time of the transaction, to guard against the possibility of self-dealing.

The broad reach of the duty has been explained as acknowledging the aspect of human nature that makes it "generally, if not always, humanly impossible for the same person to act fairly in two capacities and on behalf of two interests in the same transaction. . . . If one of the interests involved is that of the trustee personally, selfishness is apt to lead him to give himself an advantage."[30] It can

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22. *Id.* § 404(a), 29 U.S.C. § 1104(a).

23. H.R. REP. NO. 93-533, *supra* note 11, at 12, *reprinted in* 2 LEGISLATIVE HISTORY OF ERISA at 2359.

24. ERISA § 406, 29 U.S.C. § 1106. Transactional prohibitions include sales, leases, and exchanges of property; furnishing of goods, services, and facilities; transfers of plan assets; entering into loans; and plan acquisitions of employer stock or real property in excess of statutory maximums. *Id.* § 406(a)(1), 29 U.S.C. § 1106(a)(1).

25. *Id.* § 406(b)(1), 29 U.S.C. § 1106(b)(1).

26. *Id.* § 406(b)(2),(3), 29 U.S.C. § 1106(b)(2),(3).

27. *Id.* § 3(14), 29 U.S.C. § 102(14). Parties in interest include plan fiduciaries, employers, employees, unions, plan service providers, officers, directors, and 10% shareholders.

28. *See generally id.* § 408, 29 U.S.C. § 1108. For an example of an administrative exemption, see Prohibited Transaction Exemption 76-1, 41 Fed. Reg. 12,740 (1976) (exempting office lease and administrative service transactions in which multiple employer plans are involved).

29. *See* GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 543 (2d ed. 1960). Under trust doctrine, a transaction between a trustee and a trust is not void, only voidable. WILLIAM F. FRATCHER, III SCOTT ON TRUSTS § 206 (4th ed. 1988).

30. BOGERT & BOGERT, *supra* note 29, § 543.

also be justified as a means of excusing trust beneficiaries from the difficult task of assessing or proving a transaction's fairness after the fact.

The duty of loyalty also proscribes a trustee from entering a transaction for the purpose of benefitting a third party, rather than the trust beneficiary.[31] Here, though, the problems of identifying improper transactions are more difficult. In the case of self-dealing, the relevant question is not generally difficult to answer: Did the trustee deal with the trust? In the case of a transaction with a third party, however, the relevant question is: Did the trustee intend to benefit the third party? This question can be particularly nettlesome if the trustee can colorably argue that at the time of the transaction he or she was motivated by potential benefit to the trust beneficiaries, and that benefit to the third party was merely incidental.

ERISA reflects the trust law requirement of loyalty by requiring plan fiduciaries to discharge their obligations solely in the interest of the plan's participants[32] ("exclusive purpose rule") and through the prohibited transaction rules.

The combination of ERISA's prohibited transaction rules and its exclusive purpose standard are both more and less demanding than the general trust rule of loyalty. The trust rule of loyalty renders voidable a transaction between a trust and trustee.[33] ERISA, in contrast, absolutely prohibits transactions not only between a plan and fiduciary, but also between a plan and any party in interest.[34] On the other hand, ERISA includes broad exceptions to its general prohibitions.[35]

The rigorous loyalty rules embodied in ERISA are, to some extent, belied by the statute's explicit tolerance of employer fiduciaries, whose interests in plan decisionmaking may well vary from the participants who, under the statute, purportedly command absolute fidelity from plan fiduciaries.[36] Some have argued that this tolerance modifies ERISA's exclusive purpose rule by tacitly recognizing that fiduciaries will administer the plan for the benefit of both employees and employer.[37] However, the exclusive purpose rule literally denies the legitimacy of these interests, and neither ERISA's legislative history nor judicial construction of its provisions supports this view of the statute, at least not explicitly.

The second fiduciary duty imposed upon plan administrators and trustees is the duty of prudence. Trust law also imposes a duty of prudence on trustees. In 1974, when ERISA was enacted, the Restatement (Second) of Trusts standard of prudence directed the trustee "to make such investments and only such investments as a prudent man would make of his own property having in view

31. RESTATEMENT (SECOND) OF TRUSTS § 170 (1959).
32. ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1).
33. *See* FRATCHER, *supra* note 29, § 312.
34. *See supra* note 27.
35. *See supra* note 28.
36. ERISA § 408(c), 29 U.S.C. § 1108(c).
37. *See* Fischel & Langbein, *supra* note 7, at 1158.

the preservations of the estate and the amount and regularity of the income to be derived."[38]

Under this rule, courts generally tolerated investment decisions that were later found to be unwise, so long as the decisions were supportable at the time they were made.[39] Some investments, however, could never be considered prudent, especially those of a speculative nature. For example, trustees could not purchase securities on margin, or invest in speculative securities or the securities of new industries.[40] Moreover, several states historically maintained lists of permitted investments—some of which excluded common stock—though the overwhelming trend by 1974 was toward dramatically fewer restrictions.[41] However, trust law generally permitted the settlor of a trust to excuse the trustee from particular trust requirements, including any proscription of investments in common stock or other investments.

Trust law also traditionally tested prudence on a per-investment, rather than portfolio, basis, which permitted beneficiaries to attack soured investments even though the trust's overall return on investment might be strong.[42] The Restatement, however, stated that, in deciding on whether an investment is reasonable, a trustee should consider the nature of other trust investments and the particular needs of the trust, among other factors.[43] The Restatement's approach suggested that portfolio considerations could have been used to defend particular investments in some circumstances.

ERISA modified these concepts dramatically, substituting for the generalized "prudent man" of the Restatement a more flexible prudent person, one not tied to "preservation of the estate and the amount and regularity of the income to be derived."[44] Under ERISA, a fiduciary's prudence is judged in relation to the decisions of a "prudent man acting in a like capacity and familiar with such

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38. RESTATEMENT (SECOND) OF TRUSTS § 227 (1959). The classic judicial articulation of this principle is found in Harvard v. Armory, 9 Mass. (1 Pick.) 446 (1830), a case in which Harvard College argued that a trustee had acted imprudently by investing in the stock of manufacturing and insurance companies. The Court wrote that the trustee

> shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.

Id. at 461. RESTATEMENT (THIRD) OF TRUSTS introduction at 3-4 (1990) (providing a succinct history of the rule).

39. *E.g.*, Matter of Clark, 257 N.Y. 132 (1931).

40. FRATCHER, *supra* note 29, § 227.6.

41. *Id.* § 227.5. Historically, many states have prohibited investments in even publicly traded common stock, and some states retain this restriction.

42. If gain and loss result from a single breach of trust, courts may permit the gain to offset the loss for purposes of computing the loss for which the trustee must account. *See* FRATCHER, *supra* note 29, § 213. The question is whether the good investments and sour investments constitute an indivisible set of trustee decisions.

43. FRATCHER, *supra* note 29, § 227.12.

44. *Compare* ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B), *with* RESTATEMENT (SECOND) OF TRUSTS § 227. The Restatement prudence rule had provided protections for both income and remainder trust beneficiaries, concerns arguably not present in the typical employee benefit plan.

matters."[45] This standard allows fiduciaries to consider their plan's particular requirements, such as the need for liquidity, the size of the plan, the type of plan, and the ages and characteristics of the employees.

Perhaps the most important departure of the ERISA prudence rule from the traditional trust rule was the minimization of the importance of particular investments. Under ERISA, prudence is judged by the anticipated performance of the *total* portfolio given the requirements of the plan.[46] Department of Labor regulations provide that fiduciaries act prudently by giving appropriate consideration to all facts and circumstances that the fiduciary knew, or should have known, were relevant to an investment and its role in the plan's total portfolio.[47]

ERISA prefigured a revised Restatement prudent investor rule. Adopted in 1992, the revised rule[48] provides:

> The trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust.
>
> (1) This standard requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.[49]

Third, traditional trust law and ERISA generally imposed a duty on the trustee and plan administrator to diversify investments. The Restatement provides that trustees must diversify investments unless they can prove that, under the circumstances, it would not have been prudent to do so.[50]

Diversification reduces the risk of large portfolio loss by ensuring investments sufficiently diverse to minimize risks common to similar investments. Although the duty is often considered a responsibility separate and distinct from the general prudence requirement, it may also be understood as an application of the prudent man rule, since a prudent person would select every investment with at least some eye to whether the investment added to or detracted from the portfolio's diversity.[51]

Relatively few published cases or statutes exist that provide specific standards to gauge whether a trustee has satisfied a diversification requirement. However, under trust laws the duty is violated where trust assets are too heavily invested in a single company,[52] a single industry,[53] a single class of security,[54] or a

45. ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B).

46. The preamble to the Department of Labor's regulations on prudence indicates that precious metals and stock in start-up corporations—investments once barred to trusts in a number of states—may be appropriate investments for some plans. 44 Fed. Reg. 37224-25 (June 26, 1979).

47. 29 C.F.R. § 2550.404a-1 (1991).

48. RESTATEMENT (THIRD) OF TRUSTS § 227.

49. *Id.*

50. RESTATEMENT (THIRD) OF TRUSTS § 227(b); *see also* RESTATEMENT (SECOND) OF TRUSTS § 228.

51. Indeed, the Restatement moved the diversification requirement from a separate section in the second restatement to a subsection of the prudent investor rule. *Compare* RESTATEMENT (SECOND) OF TRUSTS § 228 *with* RESTATEMENT (THIRD) OF TRUSTS § 227(b).

52. Dickinson, Appellant, 152 Mass. 184 (1890), *cited in* FRATCHER, *supra* note 29, § 228.

single geographic region.[55] Courts have indicated tolerance for single investments as large as twenty-two percent of a trust fund,[56] but an English court found that an investment of as little as ten percent of a trust's assets in a single bank was too high.[57] Undoubtedly, much depends on the circumstances. For example, a small trust fund is less able to diversify than is a large one, and some investments, such as Treasury notes and highly rated corporate bonds, are safer than others.

ERISA's diversification rules do not explicitly modify traditional trust law,[58] except to the extent that ERISA generally prohibits the trust settlor from drafting the trust indenture to reduce prudence and diversification requirements.[59] As is the case with traditional trust law, ERISA does not specify numeric requirements for investment diversification. ERISA's legislative history indicates that diversification should be judged in light of the plan's purpose, the amount of assets involved in particular investments, the financial and industrial conditions at the time of investment, the degree of geographic and industrial diversity reflected in the portfolio, the mix of equity and debt in the portfolio, and the maturity dates of debt instruments.[60]

Fourth, traditional trust law requires a trustee to follow the trust indenture.[61] ERISA similarly provides that a fiduciary must act in accordance with plan documents, except to the extent the documents are inconsistent with statutory requirements.[62]

The duty to follow a trust indenture often requires trustees to exercise discretion, which may range from determining how to invest trust assets to deciding on the timing of trust distributions to beneficiaries to the identity of such beneficiaries. Thus, a rule requiring trustees to adhere to the trust instrument, or a rule requiring ERISA fiduciaries to adhere to plan documents, is only the obvious answer to the most basic question. The more difficult question is how trustees or fiduciaries should exercise the discretion extended them by the governing instrument.

To a very large extent, the exercise of such discretion is guided by the principles of loyalty, prudence, and diversification of investments. But these are essentially principles of limitation, demarcating acceptable responses to

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53. *In re* Ward, 121 N.J. Eq. 555 (1936).
54. WIS. STAT. § 881.01(2) (1991).
55. Penn. Co. v. Gillmore, 142 N.J. Eq. 27 (1948), *cited in* FRATCHER, *supra* note 29, § 228.1.
56. Dickinson, Appellant, 152 Mass. 184 (1890), *cited in* FRATCHER, *supra* note 29, § 220.
57. Astbury v. Beastley, 17 W.L.R. 638 (1869).
58. ERISA § 404(a)(1)(3), 29 U.S.C. § 1104(a)(1)(3).
59. *See* ERISA § 404(a)(1)(D) 29 U.S.C. § 1104(a)(1)(D). ERISA does, however, permit certain types of plans to invest assets primarily in employer stock. *See Id.* § 407(b), 29 U.S.C. § 1108(b).
60. H.R. CONF. REP. NO. 93-1280, 93d Cong., 2d Sess. 309 (1974), *reprinted in* 3 LEGISLATIVE HISTORY OF ERISA, *supra* note 11, at 4571. The legislative history also indicates that plans can satisfy diversification requirements by use of pooled asset funds. *Id.* at 305, *reprinted in* 3 LEGISLATIVE HISTORY OF ERISA, *supra* at 4568.
61. FRATCHER, *supra* note 29, § 186.
62. ERISA § 404(a)(1)(D), 29 U.S.C. § 1104(a)(1)(D).

discretionary decisions; they do not wholly eliminate the need to make choices. Two trust duties, neither of which is expressly manifest in ERISA's statutory standards, provide guiding principles for making discretionary choices. Because of ERISA's express incorporation of trust law principles, these duties were almost certainly intended by Congress to guide discretionary decisionmaking.

The first principle is one of reasonableness.[63] Professor Scott has described this principle as meaning that so long as a trustee

> acts not only in good faith and from proper motives, but also within the bounds of a reasonable judgment, the court will not interfere; but the court will interfere when he [or she] acts outside the bounds of a reasonable judgment. In other words, although there is a field, often a wide field, within which the trustee may determine whether to act or not and when and how to act, yet beyond that field the court will control him. How wide that field is depends upon the terms of the trust, the nature of the power, and all circumstances.[64]

The second principle, which is related to the duty to exercise discretion reasonably, is the duty of impartiality.[65] In multibeneficiary trusts, trustees will sometimes have to make decisions whose impact is not uniform among beneficiaries. The possibility of such conflicts in a pension trust is manifold. For example, a trust with insufficient resources might have to decide which of two benefit promises to fulfill; a trustee may have to decide whether to make a risky investment in an employer security, which may help preserve jobs of active employees but threaten the security of matured benefit promises to older employees and retirees.

In making such decisions, the trustee may receive some direction from the governing instrument, but more probably will be forced to make a decision without any express guidance from the settlor. A duty of impartiality toward competing beneficiaries requires trustees to make such decisions in accordance with the underlying purpose of the trust, not for the purpose of favoring one group of beneficiaries over another.[66]

B. Availability of Equitable Remedies

A dissatisfied trust beneficiary generally is limited to remedies available in equity,[67] which include the injunction, specific performance, redress for a breach (including compensation of the trust for any loss, plus payment of profits made by the trustee with the trust's assets), the undoing of a transaction, removal of the trustee, and receivership.[68] Beneficiaries' access to legal remedies against trustees is limited.[69] However, one legal remedy has relevance to trust

63. RESTATEMENT (SECOND) OF TRUSTS § 187.
64. FRATCHER, *supra* note 29, § 187.
65. *Id.* § 183; RESTATEMENT (THIRD) OF TRUSTS §§ 183, 227(c)(1).
66. Professors Fischel and Langbein have suggested that courts fasten on the rule of impartiality for purposes of judging ERISA fiduciary decisions. *See* Fischel & Langbein, *supra* note 7, at 1159-60.
67. FRATCHER, *supra* note 29, § 199.
68. *Id.*
69. *Id.* § 198. Chancery courts did have power to award monetary damages pursuant to their overall equitable jurisdiction. This has relevance in the analysis of whether ERISA permits participants

administration: A trust beneficiary may bring a damage action against a trustee who fails to pay amounts unconditionally owed to the beneficiary.[70]

ERISA has four enforcement provisions under section 502 that are relevant to the concerns of this article. Section 502(a)(1)[71] provides that a participant may bring an action to recover benefits under the plan, to enforce rights under the plan, or to clarify future rights to benefits under the terms of the plan. This section is the only ERISA enforcement section that includes provisions paralleling legal remedies.[72] Section 502(a)(2)[73] provides that a participant, fiduciary, or the Department of Labor may bring an action for relief under section 409. Section 409, in turn, provides that a fiduciary who breaches its statutory responsibilities shall be personally liable to make good plan losses, to restore to the plan profits made through use of its assets, and to provide other equitable and remedial relief. Section 502(a)(3)[74] provides that a participant or fiduciary may bring an action to obtain equitable relief to redress violations of ERISA or the terms of the plan, or to enforce provisions of ERISA or the plan. Section 502(a)(5)[75] provides that the Secretary of Labor may bring an action to obtain equitable relief to redress violations of ERISA or to enforce provisions of ERISA.

III

THE LIMITS OF EQUITY IN RESOLVING POLICY ISSUES RAISED BY EMPLOYEE BENEFIT PLANS

Congress intended, and courts have accepted, ERISA as a statute whose basic precepts were extracted from equity.[76] After a decade and a half of experience with the statute, however, those precepts have failed to resolve, or have resolved only awkwardly, fundamental and recurring questions of benefits policy. This section considers three such issues, which are each interesting, pervasive, and not

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to bring civil actions for monetary damages against persons who knowingly participate in the breach of trust. ERISA § 502(a)(3) provides that a participant may bring an action to obtain "appropriate equitable relief" to redress violations of the statute. (Section 502(a)(2) permits monetary damages against fiduciaries who breach their trust but does not mention third parties who assist fiduciaries in committing a breach of trust.) Thus, whether the statute permits actions against non-fiduciaries who participate in fiduciary violations depends on the meaning of "appropriate equitable relief." Does it encompass all sorts of relief that could be granted by a court of equity, or does it refer only to non-monetary equitable types of remedies, such as those referred to in the text? The issue is before the Supreme Court at the time of this article's publication. Mertens v. Hewitt Associates, 948 F.2d 607 (9th Cir. 1991), *cert. granted*, 113 S.Ct. 49 (1992).

70. FRATCHER, *supra* note 29, § 198. This issue is of more than academic interest; in the balance should hang the right to a jury trial. *See generally*, Note, *The Right to Jury Trial in Enforcement Actions Under Section 502(a)(1)(B) of ERISA*, 96 HARV. L. REV. 737 (1983).

71. 29 U.S.C. § 1142(a)(1).

72. The authorization of actions to recover benefits under the plan is similar to actions against trusts to recover amounts unconditionally owed to beneficiaries. *See supra* text accompanying note 70.

73. 29 U.S.C. § 1142(a)(2).

74. *Id.* § 1142(a)(3).

75. *Id.* § 1142(a)(5).

76. Firestone Tire & Rubber Co. v. Bruch, 489 U.S. 101 (1989).

adequately resolved through application of traditional equitable rules. The issues are: (1) the extent to which ERISA should permit a retirement plan to sacrifice maximum investment return in favor of achieving other benefits for participants, often referred to as "social investing"; (2) the availability of extracontractual damages to plan participants whose applications for benefits are denied in bad faith; and (3) the appropriate standard of judicial review of claims denials.[77]

ERISA's equity-based standards have obscured consideration of the real policy tradeoffs raised by each of these issues. Moreover, the courts, bereft of legislative guidance, have been unable to resolve the tradeoffs in a consistent or principled way.

A. The Permissibility of Social Investing

ERISA section 404(a)(1)(A) provides that a fiduciary shall discharge his or her duties "for the exclusive purpose of providing benefits to participants and their beneficiaries."[78] Section 404(a)(1)(B) requires that fiduciaries make prudent investment decisions. This section of the article considers the effects of these provisions on social investing by defined benefit pension plans.[79]

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77. There are other ERISA issues whose resolution might depend on the rules of equity, for example, whether a participant may obtain a jury trial under ERISA, *compare* Katsaros v. Cody, 744 F.2d 270 (2d Cir.), *cert. denied*, 469 U.S. 1072 (1984) (ERISA claims equitable in nature, jury trial not available), *with* International Union, United Automobile, Aerospace and Agricultural Implement Workers of America v. Midland Steel Products Co., 771 F. Supp. 860 (N.D. Ohio 1991) (jury trial available for claims under ERISA § 510, establishing cause of action for interference with attainment of ERISA rights); *see generally* Note, *supra* note 70, at 737. (The overwhelming weight of authority today is in opposition to jury trials).

Additional issues include how plan fiduciaries respond to tender offers for equity securities held by the plan, see Donovan v. Bierwirth, 680 F.2d 263 (2d Cir.), *cert. denied*, 459 U.S. 1069 (1982); for how plan fiduciaries should vote such securities, see Letter from David Walker to Avon Products Co. (Feb. 23, 1988), *reprinted in* 15 Pens. Rep. (BNA) 391 (1988); for whether participants enjoy estoppel remedies against plans or plan sponsors, *compare* Cartwright v. Health & Welfare Pension Fund, 771 F. Supp. 127 (D.C. Md. 1991) (finding estoppel remedy) *with* Gridley v. Cleveland Pneumatic Co., 924 F.2d 1310 (3d Cir.) *cert. denied*, 111 S. Ct. 2856 (1991) (finding no estoppel remedy); and whether a civil action may be brought by a participant against individuals for knowing participation in a fiduciary's breach of trust. *See* Mertins v. Hewitt Associates, 948 F.2d 607 (9th Cir. 1991), *cert. granted*, 113 S.Ct. 49 (1992). *See also supra* note 69.

78. 29 U.S.C. § 1104(a)(1)(A).

79. *See generally* Ronald B. Ravikoff & Myron P. Curzan, *Social Responsibility in Investment and the Prudent Man Rule*, 68 CAL. L. REV. 518 (1980) (arguing in part that social investment is permissible under ERISA); James D. Hutchinson & Charles G. Cole, *Legal Standards Governing Investment of Pension Assets for Social and Political Goals*, 128 U. PA. L. REV. 1340 (1980) (noting ERISA's constraints on social investing); John H. Langbein, *Social Investing of Pension Funds and University Endowments: Unprincipled, Futile, and Illegal, reprinted from* NATIONAL LEGAL CENTER FOR THE PUBLIC INTEREST, DISINVESTMENT (1985) (arguing that ERISA and trust law prohibit social investing); John H. Langbein & Richard A. Posner, *Social Investing and the Law of Trusts*, 79 U. MICH. L. REV. 72 (1980) (arguing against the wisdom and legality of social investing by trusts and institutions); Fischel & Langbein, *supra* note 7, at 1143-49.

This article discusses the issue in the context of defined benefit pension plans. Defined benefit plans promise a specific benefit to participants. Individual employees do not have individual accounts, and the amount of their benefit depends on a plan benefit formula. Thus, reduced investment return does not directly affect the amount of benefits, although strong investment performance certainly increases the probability that the plan sponsor will decide to improve benefits.

Two distinct types of plan investment behavior fall under the rubric of social investing.[80] The first type of social investing seeks to conform a portfolio to certain moral precepts, such as "apartheid is evil," "guns are evil," "tobacco is evil," or "abortion is evil." For example, an investment fund might seek to avoid investing in securities of businesses that produce abortifacients or that do business in South Africa. This type of social investing is problematic under ERISA because it limits the universe of possible investments, reduces opportunities for plan diversification, and, by requiring that potential investments be investigated to ensure moral rectitude, reduces return by imposing additional transaction costs on the plan.[81] It also is morally problematic because participants in most plans are unlikely to agree on what uses of plan money are morally appropriate. This article concerns itself more with the second type of social investing.

The second type of ERISA plan "social investing" occurs when a plan sacrifices maximum investment performance in return for other benefits for the plan's participants.[82] This type of investing is most common among union-negotiated, defined benefit plans. A plan in the construction trade, for example, might invest in local projects that employ its members;[83] or in below-market rate mortgages for its members;[84] or in a hospital in a rural community where many of its members reside.[85] Should the trustee be precluded from such investments if they will generate lower rates of return than other available investments with comparable levels of risk, or if they will subject the trust to risk because they detract from the plan's investment diversification?

In contrast to defined benefit plans, defined contribution plans provide a separate account for each participant, with the employer's contributions and the plan's investment income allocated among such accounts. The participant's benefit under the plan is equal to the value of his or her account. The argument for social investing from a defined contribution plan is strongest if each plan participant controls the investment decisions for his or her account. *See* Langbein & Posner, *supra*, at 105-06.

80. *See generally*, Norman Stein, *Trust Law and Pension Plans*, *reprinted in* PROXY VOTING OF PENSION PLAN EQUITY SECURITIES (Dan M. McGill, ed., 1988).

81. *See* Langbein & Posner, *supra*, note ?, at 72. Such social investing does not necessarily mean that the investments actually made, considered individually, will pay sub-market rates of return; the decision of a plan to avoid certain investments may still leave a plan with numerous market-rate investments, depending on how many investment assets are put off limits. Some social investing can, of course, result in reduced rates of return. For example, if a plan, rather than putting certain investment assets off limits, decides affirmatively to invest in local food cooperatives, the plan's rate of return on such investments might not return market rates of interest. For a persuasive description of why such social investing violates traditional trust law, see Langbein, *supra* note 79. *But see* Joel C. Dobris, *Arguments in Favor of Fiduciary Divestment of "South African" Securities*, 65 NEB. L. REV. 209 (1986) (thoughtful argument in favor of social investing).

82. *See* Fischel & Langbein, *supra* note 7, at 1142.

83. *See, e.g.*, Donovan v. Walton, 609 F. Supp. 1221 (S.D. Fla. 1985).

84. *Id.*

85. Prior to ERISA, the United Mine Workers of American Health and Retirement Fund made such investments. After ERISA, the funds were split into a retirement fund and a health and welfare funds. The latter fund continued to subsidize clinics in Appalachia for a brief period following enactment of ERISA. Helen Dewar, *Some UMW-Backed Clinics May Close*, WASH. POST, July 27, 1977, at A-3.

The Department of Labor maintains that the rule of prudence and the exclusive purpose rule do not permit a plan to sacrifice investment yield to achieve other social objectives, but that the rules do permit a plan to choose among otherwise economically equivalent investments based on incidental factors.[86] Thus, the Department has opined that a pension plan's creation of an earmarked fund that could be invested only in construction projects employing union labor was permissible if the investment criteria used to judge the investments were the same as those used to evaluate other real estate investments.[87] The Department has also granted prohibited transaction exemptions for negotiated plans that desired to extend business loans to contributing employers.[88] But these examples assume that the investments were economically equivalent (in terms of return) to other available opportunities. The Department's position, then, is that a plan may consider incidental benefits to its members but may not sacrifice investment return to realize such benefits. The Department has litigated two cases that appear to raise the issue of whether a fiduciary may sacrifice return to achieve other benefits for participants. Neither case, however, explicitly discusses the issue. In the earlier case, *Donovan v. Mazzola*,[89] a union pension fund made a $1.5 million dollar below-market interest rate loan to a related union convalescent fund, whose membership was similar, albeit not identical, to the membership of the pension fund. The Department of Labor challenged the loan as imprudent. The union trustees did not attempt to defend the pension plan's extension of favorable credit on the theory that it assisted pension participants who also were beneficiaries of the convalescent fund.[90] Instead, they argued that the loans were financially prudent, notwithstanding that they were granted at interest rates and other terms favorable to the convalescent fund. The district court found the trustees liable.[91]

The second case, *Donovan v. Walton*,[92] involved two controversial investments by the Operating Engineers Local 675 pension fund: a business develop-

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86. Section 401(a)(2) of the Internal Revenue Code mandates that the assets of a tax-qualified deferred compensation plan be used for "the exclusive benefit of employees or their beneficiaries." The Chief Counsel at the IRS issued a 1992 general counsel memorandum concluding that an employee stock ownership plan ("ESOP") would not satisfy § 401(a)(2) if it permitted the trustees to consider job-related criteria in deciding whether to tender stock in a tender offer. Gen. Couns. Mem. 39,870 (Apr. 7, 1992).

87. Department of Labor Advisory Opinion Letter to Theodore Groom (Jan. 16, 1981).

88. Northwestern Ohio Building and Construction Trades, Prohibited Transaction Exemption 85-58, 50 Fed. Reg. 11,272 (1985).

89. 716 F.2d 1226 (9th Cir. 1983).

90. An argument of this sort was made in Cutaiar v. Marshall, 590 F.2d 523 (3d Cir. 1979), where trustees of one plan defended a loan to another plan, of which they were also trustees, on the ground that the two plans had overlapping participant groups. The court noted that the participants in the two plans were not identical and found that the loan was a prohibited transaction, since the same trustees were on both sides of the negotiating table.

91. The trustees of the pension fund retained, for $250,000, an associate to prepare a feasibility study of how to best use property belonging to the convalescent fund. The facts in *Mazzola* thus suggested malfeasance bordering on outright theft.

92. 609 F. Supp. 1221 (S.D. Fla. 1985), *aff'd sub nom* Brock v. Walton, 794 F.2d 586 (5th Cir. 1986)(ruling on mortgage issue only).

ment, anchored by an office building to be leased by a union and to be constructed with union labor, and below-market interest rate home mortgages to plan participants. Because of the arrangement with the union, it seemed likely that the office development investment would pay a lower rate of return to the plan than the plan might otherwise have achieved on other investments.

The fund trustees defended the investments as prudent, without arguing that the investments provided nonretirement benefits to participants. With respect to the business development, the trustees argued that they entered into the venture with the reasonable, well-investigated, expectation of obtaining a high rate of return. They defended the below-market interest rates by arguing that the loans, though below commercial rates, paid a higher rate of return than other plan assets and were apparently consistent in terms with nontraditional mortgage loans in the area. The court rejected the Department of Labor's argument that the interest differential between the mortgages written by the plan and comparable commercial mortgages automatically meant that the loans were imprudent.[93]

Dennis Walton, a fund trustee and union officer, gave a series of speeches around the country following the case's resolution in his favor. In them, he contended that the investments were made to stimulate local union construction projects, thereby providing jobs to members and to help members purchase homes.[94] The real issue, then, was that which the court ignored: whether a pension fund may trade maximum return in exchange for investments that will increase job opportunities for participants or will provide them with low-cost home mortgages. In essence, the question is whether a fund may have a major goal (provision of retirement income) and a secondary goal (creation of job opportunities or other nonretirement benefits). In the *Walton* case, the court's holding suggests some sympathy toward sub rosa arguments that dual-purpose funds are not wrong per se; this sympathy may explain the court's holding, which, as a construction of the prudent investor rule, seems indefensible.[95]

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93. Department of Labor regulations promulgated since *Walton* was decided would treat the extension of loans bearing a below-market interest rate as prohibited transactions. 29 C.F.R. § 2550.408b-1 (1991). The regulations squarely contradict the holding in *Walton*. *See* 794 F.2d at 588.

94. An NBC documentary, the Biggest Lump of Money in the World, included a segment of one of Mr. Walton's speeches. The documentary was originally broadcast in 1986 and is available from the NBC News archives. *See also* Hilary Rosenberg, *The Pitfalls of Being a Pension Pioneer*, INSTITUTIONAL INVESTOR, Mar. 1992, at 16 (chronicling history of dispute between Walton and Department of Labor); Joel Chernoff, *Ego Leads to Dennis Walton's Downfall*, PENSION AND INVESTMENT AGE, July 8, 1991, at 1 ("[T]hrough speeches that effused charm, wit and bluster, he personally ignited the enthusiasm of dozens of Taft-Hartley plan trustees across the country to put their pension assets to work for their members.").

95. The Department of Labor's policy with respect to the permissibility of social investing reflects some ambivalence toward social investing. The Department's policy permits only "costless" social investing. *See supra* notes 87-88 and accompanying text. Yet the only kind of social investing that is "costless" is the kind that already produces market-level returns and thus has no trouble attracting investment dollars in any event. *Cf.* Alicia Munnell, *The Pitfalls of Social Investing: The Case of Public Pensions and Housing*, 1983 NEW. ENG. ECON. REV. 20 (1983).

Yet funds that engage in social investing almost certainly believe that they are accomplishing something. It is possible that the Department's position that a plan satisfies the prudent person standard

One important line of argument views a sacrifice of return to accomplish nonretirement objectives as unsupportable under ERISA. Professor John Langbein writes that such a sacrifice of return is

> unprincipled in the sense that it violates the primary policies of pension law. By reducing the financial return to the pension fund, bargain rate lending necessarily sacrifices future retirement income. For present workers it involves just that trade-off of retirement for pre-retirement income that pension plans were created to guard against. But the objection runs deeper: the benefits and the costs affect different people and in different proportions. In particular, pensioners who are already retired and who depend upon the pension fund for current retirement income would derive no benefit from subsidizing employment for current workers. . . . [T]rust investment law (and now ERISA) make it flatly illegal to sacrifice the interests of plan beneficiaries in this way.[96]

Professor Langbein's first argument is that retirement plans were intended to protect a tradeoff between current and retirement income. Nothing in federal law, however, dictates what that trade-off should be. Sponsors of defined benefit pension plans may set generous or miserly benefit levels. Once benefit levels are set, rates of return directly affect contribution rates rather than benefit levels.[97]

Professor Langbein's second argument is that sacrificing return to protect jobs or help homebuyers benefits some participants at the expense of others, which trust investment law makes illegal.[98] He notes that retirees have a single interest: maximizing plan assets. Maximizing plan assets can financially enable the plan to satisfy retiree accrued benefits and can enhance the probability that the plan sponsor will amend the plan to increase a retiree's benefits, perhaps improving the benefit to compensate for inflation's effects on the value of benefits. Using plan assets to provide jobs for active employees thus can harm a plan's retired participants.[99]

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by adopting adequate procedures to evaluate social investments' equivalency to other investments has permitted some plans to sacrifice modest amounts of return to accomplish other objectives. Either the Department is being hoodwinked or, more likely, it has decided tacitly to approve low levels of social investment.

The Department's concern in *Walton* was, it turns out, well founded; the value of the pension plan's assets, which lacked adequate diversification, have declined precipitously. *See* Rosenberg, *supra* note 94, at 16 (chronicling history of dispute between Walton and Department of Labor). Also, it should be noted that the fund involved in *Walton* was not making the challenged investments because such an approach to investments had been negotiated. Rather, it was a decision made by fund trustees.

96. Langbein, *supra* note 79, at 11.

97. Federal tax laws reflect hostility to participants using plan assets prior to retirement. Penalty taxes are imposed on tax-qualified plan distributions prior to age 59.5, I.R.C. § 72(t) (1988), and certain plans can lose their tax qualification by making in-service distributions to employees, Treas. Reg. § 1.401-1(b)(1) (1992). These provisions exist to ensure that the tax subsidy such plans enjoy is used to provide retirement income, the creation of which is the purpose of the subsidy. Use of plan assets to create jobs, rather than maximize investment return, also directs plan assets away from the goal of producing retirement income. Thus, such asset use may violate tax policy, an idea to which the text will return. *See infra* text accompanying note 104.

It should also be noted again that there are textual arguments under both the Internal Revenue Code and ERISA that social investing is illegal. *See supra* note 86 and accompanying text.

98. Langbein, *supra* note 79, at 11.

99. In some situations, it can be argued that creating job opportunities for participants will enhance the long-term viability of the pension fund when contributions are limited to such factors as hours worked. *Cf.* Withers v. Teacher's Retirement System of the City of New York, 447 F. Supp. 1248

While it seems clear that a pension plan should not sacrifice return when such sacrifice threatens a plan's ability to satisfy benefit accruals, the question is more problematic when the tradeoff is between job creation and the possibility of future benefit increases. A plan sponsor's decision to improve retiree benefits generally is not a fiduciary decision but a plan-design decision outside the sphere of ERISA's fiduciary concerns.[100] A retired participant generally is unable to object, under ERISA, to a union and employer deciding to use surplus plan assets to raise benefits for current workers only, or to reduce the employer's rate of future contributions in exchange for higher wages for current workers.[101] It is difficult to distinguish these two situations, on the basis of the rights of retirees, from a situation in which the union and employer decide to invest surplus plan assets in projects that will create jobs for current workers.[102] If Professor Langbein is suggesting that the former two situations are also objectionable, he is objecting to that part of ERISA that commits plan design decisions to the plan sponsor. In negotiated plans, plan design can occur at the bargaining table. The salient policy question in such situations is not a fiduciary or trust law question; rather, it is a question of whether to place limits on the contractual freedom of a union and an employer to design a plan. This, of course, assumes that the use of plan funds to create employment opportunities for active employees is approved by both the union and the employer, and does not threaten the security of existing benefits.

Why might a union or a firm want plan assets invested in projects that create employment opportunities for active workers? Why should a plan sacrifice investment return (and thus reduce retirement benefits) when unrelated investment capital might be attracted to local union projects if the union simply agreed to lower wages for its members? Some unions and unionized firms might believe that a bias exists in the capital markets against projects employing union labor, and that the bias is not based solely on higher wages paid to union

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(S.D.N.Y. 1978) (investment in New York City bonds made it more likely that the city would meet its funding commitments to the plan).

100. Nazay v. Miller, 949 F.2d 1323 (3rd Cir. 1991).

101. There may, however, be grounds for raising such arguments if the trustee acting as fiduciary, rather than the employer acting as plan sponsor, formulates decisions about the plan's benefit structure. This is not uncommon under certain collectively bargained plans. Under the Taft-Hartley Amendment to the Labor Management Relations Act, 29 U.S.C. § 186(c)(5) (1988), which includes an exclusive benefit rule, courts have overturned trustee decisions on benefit structure, but recent decisions suggest that such reversals will be rare in the future. *See* Phillips v. Alaska Hotel & Restaurant Employees Pension Fund, 944 F.2d 509 (9th Cir. 1991) (refusing to hold invalid vesting requirements under which only four percent of plan participants ever vest). In any event, retirees would have no cause of action if the decision on how to structure benefits were made at the bargaining table. While courts have recognized a private cause of action for violation of a duty of fair representation, unions are not required to represent the interests of retirees.

102. Moreover, there are situations in which retirees have little arguable moral or economic claim to increased benefits. Assume, for example, that during a participant's work life a plan promised generous benefits but was poorly funded. The participant retires and his benefits are paid with a combination of accumulated plan assets and current plan contributions. Such a participant has no compelling claim to increased benefits if, at some later time, the plan achieves secure funding levels through increased plan contributions.

employees but also on ideological considerations. Investment of plan assets in union projects might correct the bias in a way that lowered wage demands could not. Moreover, firms employing union labor might believe that pension investments in local development projects increase worker productivity by giving employees a more direct stake in the enterprise.[103]

This article does not necessarily disagree with Professor Langbein's conclusion that retirement plans should be restrained from sacrificing return to effect other goals. Strong, though arguably not compelling, policy reasons exist to limit the use of plan assets. From the perspective of the tax system, for example, use of pension assets to provide nonpension benefits to participants misdirects the tax subsidy that pension plans enjoy.[104] Multipurpose plans also raise more complex regulatory problems than single purpose plans, particularly with respect to ensuring the plan's ability to satisfy already accrued benefits.[105] But similar objections might also be made with respect to ESOPs,[106] which labor and tax laws permit.

Although these objections are serious, they have little to do with traditional trust law. ERISA's legislative history furnishes scant evidence that Congress seriously considered the permissibility of social investing, particularly the kind of social investing that provides pecuniary advantage to a significant class of participants. The Department of Labor and the courts have used the vocabulary of prudence and exclusive purpose in discussing the permissibility of such social investing, but this approach begs the real issue: Should retirement plans be permitted to invest their assets in a way that expands employment opportunities or to provide other benefits for participants? The trust law principles embodied in ERISA do not furnish a fully considered answer to that question.

B. Extracontractual Damages Under ERISA

One of the congressional goals in enacting ERISA was to provide participants with adequate remedies to enforce benefit rights. House and Senate committee reports noted that

> participants lose their benefits not because of some violation of federal law, but rather because of the manner in which the plan is executed with respect to its contractual requirements of vesting or funding. Courts strictly interpret the plan

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103. Advocates of employee stock ownership plans ("ESOPs")—a type of plan that invests in employer stock and thus gives employees an ownership interest in the employer—argue that such plans increase worker productivity. *See* Henry Hansmann, *When Does Worker Ownership Work? ESOPS, Law Firms, Codetermination, and Economic Democracy*, 99 YALE L.J. 1749, 1761-70 (1990) (summarizing claims of possible benefits of worker ownership). Professor Hansmann, however, questions whether ESOPs, in their present incarnation, increase worker productivity. *Id.* at 1811-12.

104. *See* Langbein, *supra* note 79, at 26.

105. Social investing under such a regime should be confined to well-funded plans. It should be noted that social investing by under-funded plans presents a risk not only to retirees, but also to the Pension Benefit Guaranty Corporation.

106. ESOPs are sometimes used to raise capital for an otherwise failing firm, thereby providing jobs. Moreover, employers sometimes sponsor such plans as a tax-advantaged means of corporate finance, with less benefit to the employees than an ordinary retirement plan. *See generally* Hansmann, *supra* note 103.

> indenture and are reluctant to apply concepts of equitable relief or to disregard technical document wording.[107]

Two enforcement provisions under ERISA seem to support jurisdiction of a participant's action for damages resulting from a benefit denial. Section 502(a)(1)(B) vests a participant with the right to bring an action "to recover benefits due to him under the terms of his plan."[108] Section 501(a)(3), in turn, provides that a participant may bring a civil action "to enjoin any act or practice which violates any provision of this title or the terms of the plan, or to obtain other appropriate equitable relief to redress such violations or to enforce any provisions of this title or the terms of the plan."[109] A benefit action, at least theoretically, can be brought under the latter jurisdictional grant because a failure to pay contractual benefits runs afoul of ERISA section 404(a)(1)(D), which requires fiduciaries to discharge their duties in accordance with plan documents.

The jurisdictional provisions are, despite their overlap, fairly rudimentary; they do not detail the scope of rights and remedies available to participants. The legislative history of ERISA suggests that Congress "intended that a body of Federal substantive law will be developed by the courts to deal with issues involving rights and obligations under private welfare and pension plans."[110] In any event, because the enforcement provisions lack detail and specificity, many questions concerning the scope of procedural rights and substantive remedies necessarily were left to the federal judiciary.

This section of the article considers a remedies issue that has vexed the federal courts: whether there are circumstances under which participants may recover extracontractual damages (including punitive damages) in an ERISA benefits action.[111] Judicial analysis of this question has, by and large, focused on whether extracontractual damages were a traditional equitable remedy.[112] The consideration of statutory purpose is relegated to background noise.[113] As a result, the courts have fashioned a troublesome body of law that has immunized plan administrators against meaningful damage awards and failed to make beneficiaries whole.[114]

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107. H.R. REP. NO. 93-533, *supra* note 11, at 17, *reprinted in* 2 LEGISLATIVE HISTORY OF ERISA at 2364.

108. 29 U.S.C. § 1142(a)(1).

109. *Id.* § 1142(a)(3).

110. 120 CONG. REC. 29,942 (1974) (remarks of Senator Javits).

111. *See, e.g.*, Harsch v. Eisenberg, 956 F.2d 651 (7th Cir.), *cert. denied*, 113 S. Ct. 61 (1992); McRae v. Seafarers' Welfare Plan, 920 F.2d 819 (11th Cir. 1991); Davis v. Kentucky Fin. Cos. Retirement Plan, 887 F.2d 689 (6th Cir. 1989), *cert. denied*, 495 U.S. 905 (1990); Drinkwater v. Metropolitan Life Insurance Co., 846 F.2d 821 (1st Cir.), *cert. denied*, 488 U.S. 909 (1988).

112. Harsch v. Eisenberg, 956 F.2d at 656-60.

113. *Id.* at 655 (Although holding against plaintiff, the Seventh Circuit saw "good reasons to allow beneficiaries to recover extracontractual damages under ERISA.").

114. State law remedies are not available because of ERISA preemption. ERISA § 514, 29 U.S.C. § 1144.

McRae v. Seafarers' Welfare Fund[115] is typical of the genre of cases involving claims for extracontractual damages where the plan wrongfully fails to pay benefits. Vivion McRae was a participant in a union health benefits plan. Mr. McRae's wife wished to have a tubal reanastomosis, a minor surgical procedure to reverse an earlier sterilization. The McRaes' doctor's insurance clerk called a plan representative to ask whether the cost of the procedure would be covered. The representative informed the clerk that the procedure was covered. Mrs. McRae had the procedure.

The plan paid some hospital bills and the anesthesiologist's fees, but later determined that a plan limitation on elective surgery barred payment for the surgery. It therefore refused to pay the surgeon's bill and requested that the hospital and anesthesiologist return the payments already made. (The hospital complied; the anesthesiologist did not.) The McRaes' credit rating was adversely affected: they were denied loans and collection agencies pressured them to pay the bills the plan refused to pay.

The McRaes brought a civil action under section 502(a)(3) seeking payment of the medical expenses the plan had initially agreed to pay, as well as damages for consequential injuries they had suffered (such as damage to their credit rating) and punitive damages. The district court ruled in their favor and ordered the plan to pay expenses and $50,000 in other damages.

The Court of Appeals for the Eleventh Circuit reversed, holding that the "equitable relief" available under section 502(a)(3) did not extend to extra-contractual damages.[116] The Court relied on dicta in *Russell v. Massachusetts Mutual Insurance Co.*,[117] a Supreme Court case in which a participant sought punitive damages under section 409 of ERISA[118] against a plan fiduciary who allegedly inflicted injury on the participant by failing to process a disability claim in a proper and timely manner. Under section 409, a participant may sue a fiduciary in breach of ERISA's requirements. The court may order a fiduciary to "make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary";[119] the fiduciary is also "subject to such other equitable or remedial relief as the court may deem appropriate."[120]

The Supreme Court ruled against the participant in *Russell*, finding that section 409 was concerned with the relationship between the *plan* and the plan fiduciary, and not that between the *participant* and the fiduciary.[121] Thus, the

115. 920 F.2d 819 (11th Cir. 1991).
116. *Id.* at 821.
117. 473 U.S. 134 (1985).
118. 29 U.S.C. § 1109.
119. *Id.*
120. *Id.*
121. *Russell*, 473 U.S. at 140. The Court focused on the fact that § 409 provided that the fiduciary compensate the plan for its losses and restore to the plan profits that the fiduciary made using plan assets. Thus, the Supreme Court interpreted § 409 as creating a type of derivative action in which plan participants could sue a breaching fiduciary on behalf of the plan.

section did not provide a jurisdictional basis for an action seeking damages of any sort in favor of a participant; rather, a participant could bring a lawsuit derivatively to seek damages on behalf of the plan itself. The Court reserved judgment on whether a participant could recover punitive damages under section 502(a)(3), which authorizes participants to obtain "appropriate equitable relief" to redress statutory violations or to enforce plan terms.[122]

The Court, in dicta, went further, however, observing that ERISA's legislative history indicated congressional intent to limit remedies to those specifically enumerated in the statute. An award of punitive or other extracontractual damages is a legal remedy.[123] Section 502(a)(3), which provides for various forms of equitable relief, does not authorize a participant to seek a legal remedy.[124]

The Court, in reaching its conclusion, acknowledged "that an early version of the statute contained a provision for 'legal or equitable' relief" and that this was

> described in both the Senate and House Committee Reports as authorizing "the full range of legal and equitable remedies available in both state and federal court." But, that language appeared in Committee Reports describing a version of the bill before the debate on the floor and before the Senate-House Conference Committee had finalized the operative language. In the bill passed by the House of Representatives and ultimately adopted by the Conference Committee the reference to legal relief was deleted.[125]

A majority of the Court therefore concluded that the enforcement provisions of ERISA only authorized actions to recover actual benefits under the terms of the plan (under section 502(a)(1)(B)) or to obtain equitable relief (under section 502(a)(3)). The Court's opinion thus suggests that the enforcement scheme did not expressly contemplate the award of punitive damages, and the Court was unwilling to find an implied right to such an award.[126] The Eleventh Circuit relied on this construction of the statute in holding against the McRaes.[127]

The Supreme Court's construction of the statute is certainly plausible. However, the Court appears to have misread ERISA's legislative history. The Court correctly noted that the committee report accompanying H.R. 2, the House bill, stated that H.R. 2 provided "the full range of legal and equitable

122. 29 U.S.C. § 1132(a)(3).

123. Section 502(a)(1), 29 U.S.C. § 1132(a)(1), authorizes participants to bring civil actions "to recover benefits due . . . under the terms of [the] plan." Section 502(a)(1) thus prescribes a legal remedy, although one limited to recovery of plan benefits.

124. The Supreme Court framed the issue as whether ERISA implied a cause of action for extracontractual damages; this issue would have been moot if the statute were interpreted to provide express legal remedies, though in that case a question might have arisen about whether the legal remedies were limited to those available in contract.

125. *Russell*, 473 U.S. at 145-46.

126. Justice Brennan, writing a concurrence joined by Justices Mashall, White, and Blackmun, disavowed the dicta in the principal *Russell* opinion on the availability of extracontractual damages under § 502(a)(3). *Russell*, 473 U.S. at 149 (Brennan, J., concurring).

127. *McCrae*, 920 F.2d at 821-22. A few district courts have reached a contrary result, holding that equity permitted punitive damages to be awarded against a fiduciary. *See, e.g.*, Schoenholtz v. Doniger, 657 F. Supp. 899, 914 (S.D.N.Y. 1987).

remedies."[128] The complete language of the passage noted by the Court is worth quoting:

> The intent of the Committee is to provide the full range of legal and equitable remedies available in both state and federal courts and to remove jurisdictional and procedural obstacles which in the past appear to have hampered effective enforcement of fiduciary responsibilities under state law for recovery of benefits due to participants.[129]

The Court's apparent error in reading the legislative history was its suggestion that the "equitable and legal" relief language rejected by the conferees appeared in H.R. 2 as described by the report. In fact, the language appeared only in the Senate bill;[130] H.R. 2 as originally proposed contained no comparable provision and nowhere explicitly referred to the availability of "legal relief."[131] Yet the committee report accompanying H.R. 2 nevertheless indicated that the bill was intended to provide for the full range of legal and equitable remedies.[132] The House bill included a provision permitting participants to bring actions seeking to recover benefits under the plan.[133] This provision did not characterize the relief available thereunder as either legal or equitable in nature. The drafters of the House bill might have believed that this provision authorized the full range of legal remedies. The provision survived conference as section 502(a)(1)(B).

It is plausible that the Senate conferees were willing to delete the reference to legal relief in the Senate enforcement provisions because they believed that section 502(a)(1)(B) authorized courts to award various forms of legal relief.[134] Such an understanding of the legislative history would be consistent with the history's suggestion that "substantive law will be developed by the courts to deal with issues involving rights and obligations under private welfare and pension plans."[135]

Another possible reading of the statute that would square with the House committee report is that the House believed section 409 authorized legal relief in favor of plan participants; the section permits participants (as well as

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128. H.R. REP. NO. 93-533, *supra* note 11, at 17, *reprinted in* 2 LEGISLATIVE HISTORY OF ERISA at 2364.

129. *Id.*

130. S.4, 93d Cong., 1st Sess. § 602 (1973).

131. The markup of H.R. 2 altered the bill's enforcement provisions; at no stage, however, did H.R. 2 provide explicitly for legal relief. *Compare* H.R. 2, REP. NO. 93-533, *supra* note 11, at 31 (§ 106(e) in H.R. 2 as originally proposed), *reprinted in* 2 LEGISLATIVE HISTORY OF ERISA, at 2211 *with id.* at 154 (§ 501(e) following markup), *reprinted in* 2 LEGISLATIVE HISTORY OF ERISA, at 2334.

132. H.R. REP. NO. 93-533, *supra* note 11, at 17, *reprinted in* 2 LEGISLATIVE HISTORY OF ERISA at 2364.

133. H.R. 2, *supra* note 131, at 154, *reprinted in* 2 LEGISLATIVE HISTORY OF ERISA, at 2334.

134. The bill that the Senate sent to conference did not include a provision comparable to § 502(a)(1)(B). The Senate bill provided a participant denied benefits with a choice of accepting arbitration or bringing a civil action under § 693, which provided jurisdiction for "appropriate relief, legal or equitable" for violations of ERISA. H.R. 2 in the Senate, 93d Cong., 2d Sess. 566-70 (1934), *reprinted in* 2 LEGISLATIVE HISTORY OF ERISA at 3813-817. Section 693(b), with the reference to "legal relief" omitted, became ERISA § 502(a)(3).

135. 120 CONG. REC. 29,942 (remarks of Senator Javits).

fiduciaries and the Department of Labor) to bring actions seeking "equitable and remedial relief."[136] The term "remedial" in this context suggests an expansive notion of the form relief might take in a given case. Although in *Russell* the Court held that section 409 relief runs only in favor of the plan, a respectable argument could have been made that this reading is too narrow.

Although each of the suggested readings of the statute is consistent with the language in the House report, neither reading is compelled by the actual language of the enforcement scheme. In addition, both readings are inconsistent with the *Russell* dicta. *Russell*, although offering a plausible literal construction of the statute, relies on a defective account of the statute's legislative history to support that construction.[137]

The *Russell* approach permits a plan administrator to deny or delay meritorious claims with near impunity, in effect telling the participants that if they want their benefits, they must hire a lawyer and sue. Some participants will not sue because often it is difficult to find a lawyer to take small ERISA claims.[138] Those participants who do sue may have to wait years until the suit is resolved and benefits are actually paid. In any event, the benefits that will be paid are only those that should have been paid in the first place.

While failures to pay benefits are not without possible costs to the plan—the Labor Department might, for example, bring an enforcement action against the fiduciary and a court might award attorney's fees against the plan fiduciary—the reality, in many cases, is that losing a civil action means only that the plan must pay benefits. In *McRae*, for example, the Eleventh Circuit denied attorney's fees, even though the McRaes prevailed in their claim to benefits.[139] As a result, a plan has little statutory incentive to pay benefits unless it is sued.[140]

Thus, the result in *McRae* has clear costs in terms of benefit delivery, especially for the elderly on fixed incomes and for anyone with serious and pressing medical needs.[141] Arguably, the result in *McRae* also has systemic

136. 29 U.S.C. 1109.

137. *See supra* notes 125-32 and accompanying text.

138. *See ERISA Enforcement: Hearing Before the Subcomm. on Labor of the Comm. on Labor and Human Resources*, 101st Cong., 2d Sess. 50 (1990) [hereinafter *ERISA Enforcement Hearings I*] (testimony of Jeffrey Lewis on behalf of National Employment Lawyers Association, discussing in part difficulty ERISA plaintiffs have in retaining counsel).

139. In *McRae*, a separate Eleventh Circuit panel heard the attorney's fee issue. The panel held that the district court had erred in awarding fees because attorney's fees are a form of extracontractual damages. The panel ignored ERISA § 502(g), 29 U.S.C. § 1132(g), which vests in the district court discretionary authority to award attorney's fees. *See* McRae v. Seafarer's Welfare Plan, 933 F.2d 1021 (11th Cir. 1991).

140. Most plans will, of course, pay benefits, for reasons both moral and reputational.

141. Jeffrey Lewis, an attorney testifying on behalf of the National Employment Lawyers Association before the Senate Subcommittee on Labor, told a story about a participant in a health benefits plan who needed a bone marrow transplant to treat testicular cancer. Like the McRaes, he had received preauthorization from the plan insurance company to get the operation. He proceeded through the first step of the multi-step procedure when the insurer withdrew its authorization. He hired an attorney, and ultimately the insurer agreed to pay for the procedure. Mr. Lewis testified, however, that in the meantime "his medical condition deteriorated to the point where it may not be curable anymore and he suffered untold emotional stress, obviously, over the anxiety of whether he was going to get treatment

benefits, for it spares plan administrators who act in good faith the prospect of being sued for extracontractual damages. This decision may help create a climate that fosters plan formation. On the other hand, the prospect of extracontractual damages would not be nightmarish for employers if awards were limited to cases of bad faith claims denials. Moreover, ERISA cases are generally tried before federal judges, who as a group are not known for awarding exorbitant judgments.

Ultimately, the question of whether participants should be able to seek extracontractual damages should be resolved on the basis of these competing policies. But Congress failed to do so and gave the courts no basis on which to resolve the policies. The judiciary's approach—asking whether extracontractual damages are a form of equitable relief—turned a hard policy question into an easy-to-answer but essentially arbitrary inquiry.[142]

C. Standard of Review of Plan Decisions to Deny Benefits

Fiduciaries of employee benefit plans must resolve questions of benefit eligibility.[143] Such questions often involve interpreting ambiguous plan provisions or determining disputed facts. How is a fiduciary to decide whether to pay the benefit? And how is a court to review a denial of the benefit?

The answers to these questions depend on how we characterize the employee benefit promise. Prior to ERISA, the benefit promise was often regarded as contractual in nature.[144] A participant who was denied benefits could bring an action for breach of contract against the employer and the plan. But actions grounded in contract were fraught with peril for the employee, since pension plans often gave the power of determining benefit eligibility to the employer (or the plan administrator, who acted for the employer). Such plans commonly

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or not." *See ERISA Enforcement Hearings I*, *supra* note 138, at 51 (testimony of Jeffrey Lewis).

142. *See* Harsch v. Eisenberg, 956 F.2d 651 (7th Cir.), *cert. denied*, 113 S. Ct. 61 (1992). In some cases, courts have permitted awards of damages in excess of plan benefits. The most significant case involved a fiduciary who paid benefits in a manner that prevented participants from rolling over their contribution to an individual retirement account, *see* I.R.C. § 402(a)(5), causing immediate taxation of the benefits. The Sixth Circuit Court of Appeals, over a dissent, permitted the participant to recover damages from the plan fiduciary to compensate for the extra tax. *See* Warren v. Society Nat'l Bank, 905 F.2d 975 (6th Cir. 1990), *cert denied*, 111 S. Ct. 2256 (1991). The Sixth Circuit reasoned that these damages, which were foreseeable, were not the type of extracontractual damages considered in *Russell*; rather, the pension plan required the fiduciary to pay benefits in the manner directed by the participant. Equitable relief under § 502(a)(3) extended to money damages to make the participant whole.

In 1991, Congress considered a bill to create an exception to ERISA's preemption of state law in cases of bad faith denial of benefit claims, which would have permitted employees to seek legal damages in many state courts. *See H.R. 1602 and H.R. 2782: Bills Relating to ERISA's Preemption of Certain State Laws: Hearing Before the Subcomm. on Labor-Management Relations of the Comm. on Education and Labor*, 102d Cong., 1st Sess. 3 (1991).

143. *See, e.g.*, Firestone Tire & Rubber Co. v. Bruch, 489 U.S. 101 (1989) (severance benefits); Brown v. Blue Cross & Blue Shield of Alabama, Inc., 898 F.2d 1556 (11th Cir. 1990), *cert. denied*, 111 S. Ct. 71 (1991) (medical benefits); Harm v. Bay Area Pipe Trades Pension Plan Trust Fund, 701 F.2d 1301 (9th Cir. 1983) (pension benefits).

144. *See* Note, *supra* note 10, at 922. However, as late as the 1960s some courts treated pensions as unenforceable promises to make a future gift. *See, e.g.*, McNevin v. Solvay Process Co., 167 N.Y. 530 (1901); Dolge v. Dolge, 75 N.Y.S. 386 (1902).

characterized the determination of benefit entitlement as final and binding.[145] Some courts regarded such provisions not as ousting them from reviewing contractual rights, but as limiting them to reviewing whether the employer had acted in good faith.[146] In such cases, a court could rule for an employee only if the employee proved that the employer had acted in bad faith.

Some courts applied a more stringent standard of review, holding that the pension contract was a contract of adhesion, to be interpreted against the drafter,[147] at least with respect to language vesting the employer with unreviewable authority to make benefit determinations. A court taking such a view might interpret the language of benefit entitlement de novo, giving no deference to the employer's construction of the plan, or might even interpret the language against the employer who had drafted it.[148]

Which approach is correct as a matter of policy under ERISA? Respectable arguments can be made on either side of the issue. For limiting the employer's right to latitude in making benefit decisions, one can argue that ERISA's purpose is to protect the interests of employees in benefit plans,[149] and that judicial treatment of benefit entitlement questions as questions of ordinary contract interpretation best effects such a policy.[150] Any other policy, carried to its logical conclusion, would allow an employer to adopt a plan in which the employer reserved the right to make benefit decisions on a discretionary, ad hoc basis.[151] This result is inconsistent with the notion, embedded in ERISA, that benefits are in fact earned wages, which by their nature would be ascertainable, rather than gratuities.

The counterargument is that the government should interfere with the actual details of the pension contract only to the extent necessary to effect clearly articulated and compelling policy goals.[152] Both employers and employees have continuing interests in pension plans.[153] The employers' interests include retention of some control over benefit costs and flexibility to structure benefits to contribute to firm productivity. Allowing a firm to bargain for some discretionary authority in making benefit determinations provides it with a cost-controlling mechanism and a means of effecting such strategies. Any rule denying such authority will make employers less likely to sponsor a benefit plan

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145. *See,* Siegel v. First Pennsylvania Banking and Trust Co., 201 F. Supp. 664 (E.D. Pa. 1961).

146. *Id.* For similar reasoning under trust law doctrine, as it developed under the Taft-Hartley Act, see *infra* notes 157-69 and accompanying text.

147. Thornberry v. MGS Co., 176 N.W.2d 355 (Wis. 1970); Landro v. Glendenning Motorways, Inc., 625 F.2d 1344 (8th Cir. 1980).

148. *See supra* note 147.

149. ERISA § 2(b), 29 U.S.C. § 1001(b).

150. *See* Brief of American Association of Retired Persons in Firestone Tire & Rubber Co. v. Bruch, 489 U.S. 101 (1989).

151. *But see* Hamilton v. Air Jamaica, Ltd., 945 F.2d 74 (3d Cir. 1991) (holding that employer could establish plan in which employer reserved right to make entirely discretionary awards of severance pay).

152. ERISA standards in areas such as vesting, survivor rights, and coverage are examples.

153. Fischel & Langbein, *supra* note 7, at 1117-19.

and will reduce the employer's willingness to offer generous benefits.[154] Moreover, the employer's reputational concerns generally should constrain it from opportunistic behavior.[155]

In ERISA, Congress did not fashion a clear choice among these policy perspectives, and the legislative debates on ERISA are virtually silent with respect to how fiduciaries should make benefit determinations or the standard courts should use to review them. Without clear statutory guidance, the courts have looked to trust and labor law for answers.[156] Perhaps not surprisingly, courts have fumbled with the issue.

Prior to the Supreme Court's decision in *Firestone Tire & Rubber Co. v. Bruch*,[157] a majority of federal courts held that a fiduciary's decision should be upheld unless "unreasonable" or "arbitrary and capricious."[158] Under trust law, a trustee acts unreasonably if it uses trust assets to advance its interests or those of a third party, rather than those of the participants.[159] If trust law is the analogy, this suggests that ERISA courts should have found unreasonable the trustee decisions that saved the employer the expense of paying benefits.[160]

Yet ERISA courts often failed to probe fiduciary decisions for such inherent conflicts of interest. Rather, they upheld benefit denials unless "arbitrary and capricious," which translated roughly as upholding denials based on plausible readings of the plan language, at least as long as the reading was not inconsistent with prior plan practice.[161] One explanation for these decisions is that courts

154. *Id.* at 1158.

155. *Id.* at 1128-38. If statutory restraints on an employer's ability to contract for discretionary benefits are appropriate, they should be limited to circumstances in which the firm has an opportunity to behave opportunistically. For example, consider an employer closing a plant who must decide whether to pay severance benefits to a group of employees severed from further dealings with the employer. Professors Langbein and Fischel argue that courts can impose such a standard by asking what the parties would have agreed to ex ante if they had negotiated over the particular decision. They suggest that the employees would not have bargained to permit the employer to engage in opportunistic behavior.

156. *See, e.g.*, Harm v. Bay Area Pipe Trades Pension Plan Trust Fund, 701 F.2d 1301 (9th Cir. 1983) (drawing from law developed under the Taft-Hartley Act, 29 U.S.C. § 186(c)(5) (1988)); Firestone Tire & Rubber Co. v. Bruch, 489 U.S. 101 (1989) (drawing from trust principles).

157. 489 U.S. 101 (1989).

158. *See, e.g.*, *Harm*, 701 F.2d 1301 (1983) (drawing standard of review from Taft-Hartley cases).

159. RESTATEMENT (SECOND) OF TRUSTS § 187 cmt. e (Dishonest conduct is not reasonable.).

160. One can make a strong argument that if a plan administrator acts as a fiduciary when it denies benefits, its actions should be consistent with ERISA § 404(a)(1)(A). This section requires the fiduciary to base its decisions solely on whether they are for the purpose of providing benefits to participants and their beneficiaries. This standard would seemingly mandate that close questions of benefit eligibility always be resolved in the employee's favor. Perhaps the one exception that such a reading of § 404(a)(1)(A) would permit is a decision going against an employee because the fiduciary has found that the employer would recover the cost of the benefit by amending the plan to reduce benefits for other employees.

161. *See* Cook v. Pension Plan for Salaried Employees, 801 F.2d 865, 870 (6th Cir. 1988) ("[W]here both the trustee . . . and a rejected applicant offer rational, though conflicting interpretations of the plan provisions, the trustee's interpretation must be allowed to control."); *cf.* Block v. Pitney Bowes, Inc., 952 F.2d 1450 (D.C. Cir. 1993) (distinguishing the pre-Firestone law which had held that the "key to the arbitrary and capricious standard is that if there is more than one action considered reasonable, the court must not overturn a decision found to be reasonable even if an alternative decision could also be considered reasonable"). But see *infra* note 172 for cases questioning application of the arbitrary and

mechanically adopted this standard of review from case law under the Taft-Hartley amendments to the Labor Management Relations Act.[162]

The Taft-Hartley Act required that union pension and welfare benefit plans be jointly administered by labor- and management-appointed trustees for the exclusive benefit of employees and their families.[163] Taft-Hartley plans commonly gave their trustees authority to set benefit levels and conditions for benefits eligibility.[164] Participants in such plans occasionally brought civil suits challenging trustee actions as arbitrary and capricious, and thus inconsistent with the Act's rule that the trustees administer the plan for the exclusive purpose of benefitting employees and their families.[165] Some courts accepted these arguments, reversing Taft-Hartley trustee decisions if they were found to be arbitrary and capricious.[166]

Post-ERISA courts that adopted this Taft-Hartley standard generally did so without considering the different natures of the questions arising under ERISA and Taft-Hartley.[167] The Taft-Hartley Act did not provide jurisdiction for employees to bring civil actions to recover benefits; rather, the arbitrary and capricious standard furnished participants the jurisdictional basis to challenge dishonest and arbitrary trustee behavior. In contrast, ERISA furnishes explicit jurisdiction for actions to recover benefits.[168] Moreover, Taft-Hartley trustees typically set benefit eligibility standards and levels, decisions that allocate finite plan resources among various classes of plan beneficiaries.[169] Since there is no correct answer to the question of how to allocate resources, a court cannot review such decisions on a "right or wrong" contractual basis. A court can only ask if the allocation was a reasonable one.[170] In typical ERISA cases, however, the court reviews the plan administrator's construction of particular plan language, for which there is a "correct" answer.

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capricious standard of review when plan fiduciary had conflicting interest.

162. *See Harm*, 701 F.2d 1301.

163. 29 U.S.C. § 186(c)(5).

164. *See, e.g.*, Phillips v. Alaska Hotel & Restaurant Employees Pension Fund, 944 F.2d 509 (9th Cir. 1991) (plan trustees refused to adopt liberalized vesting rules); Gomez v. Lewis, 414 F.2d 1312 (3d Cir. 1969) (rule adopted by United Mine Workers of America Welfare and Retirement Funds denying benefit credit for periods in which miners were connected with mine ownership); Roark v. Boyle, 439 F.2d 497 (D.C. Cir. 1970) (rule denying pensions to miners unless pre-retirement year of employment served with a signatory employer); Toensing v. Brown, 374 F. Supp. 191 (N.D. Cal. 1974), *aff'd*, 528 F.2d 69 (9th Cir. 1975) (rule increasing pensions to carpenters who retired after June 30, 1971 in excess of increases to carpenters who retired before then).

165. *See supra* note 163 and accompanying text.

166. *Id.*

167. *See* Van Boxel v. Journal Co. Employees' Pension Trust, 836 F.2d 1048, 1052 (7th Cir. 1987) (noting that courts adopted the Taft-Hartley arbitrary and capricious standard without "noticing that employers held the whip hard in ERISA trusts as they did not with the joint employer-union trust funds authorized by Taft-Hartley").

168. ERISA § 502(a)(1)(B), 29 U.S.C. § 1132(a)(1)(B).

169. 29 U.S.C. § 186(c)(5).

170. The fact that Taft-Hartley trusts are jointly managed by labor- and management-appointed trustees also creates some confidence that the decisionmakers are not operating under a conflict of interest, although it is certainly possible that these trustees will sometimes have common interests that are not necessarily consistent with the welfare of the plan participants.

Some post-ERISA courts justified deferral to plan administrators in part because the administrator was more familiar than the court with plan operations and employee and employer expectations.[171] One could question the wisdom of this approach. Generally, the administrator is an employee of the plan sponsor, which often leads to implicit conflicts of interest.

In the 1980s, a few post-ERISA courts began questioning the suitability of deferential review of plan administrative decisions in situations where the plan administrator had a conflict of interest.[172] The issue ultimately reached the Supreme Court in *Firestone*.[173]

Firestone sponsored an unfunded salary continuation plan, which provided benefits for employees laid off because of a reduction in work force. The plan, however, did not define when such layoffs occurred. Firestone sold one of its divisions to an unrelated employer. The new employer hired most of the division's employees, though on terms different from Firestone's. The central issue in the case was whether employees retained by the new employer had lost their jobs and were therefore eligible for benefits under the Firestone plan. Since the plan was unfunded, Firestone was directly liable for any benefits owed.

The plan administrator decided that the plan did not require payments to the retained employees. Some employees disagreed and brought a civil action against Firestone, arguing that the administrator had erred in interpreting the plan. In the district court, Firestone contended that the court could only review the administrator's interpretation of the plan for reasonableness. The district court agreed and upheld the administrator's decision.

The Third Circuit Court of Appeals reversed, holding that a court should not accord deference to the decision of a fiduciary who "is thought to have acted in his own interest and contrary to the interest of the beneficiaries."[174] Rather, the court held, judicial review of such a decision should be de novo. The Supreme Court granted certiorari.[175]

The Court first held that because ERISA "abounds with the language and terminology of trust law," the courts need to be "guided by principles of trust law" in determining "the appropriate standard of review."[176] The Court then observed that, under trust law, an appellate court should defer to a fiduciary exercising discretionary power. However, the Court further observed that a

171. *See* Berry v. Ciba-Geigy Corp., 761 F.2d 1003, 1006 (4th Cir. 1985) (arbitrary and capricious "standard exists to ensure that administrative responsibility rests with those whose experience is daily and continual, not with judges whose exposure is episodic and occasional").

172. *See Van Boxel*, 836 F.2d 1048 (1987) (suggesting a flexible arbitrary and capricious standard giving only slight or no deference when plan fiduciary is under a conflict of interest); Jung v. FMC Corp., 755 F.2d 708, 711-712 (9th Cir. 1985) (suggesting flexible arbitrary and capricious standard); Bruch v. Firestone Tire & Rubber Co., 828 F.2d 134 (3d Cir. 1987) (rejecting arbitrary and capricious standard where fiduciary has conflict of interest), *aff'd on different grounds*, Firestone Tire & Rubber Co. v. Bruch, 489 U.S. 101 (1989).

173. 489 U.S. 101 (1989).

174. *Bruch*, 828 F.2d at 145.

175. *Cert. granted*, 485 U.S. 986 (1988).

176. 489 U.S. 101, 110-11 (1989).

trustee has discretionary power to interpret ambiguous plan language only if the trust instrument specifically vests the trustee with such powers. Since the plan in *Firestone* did not vest the plan administrator with such power, the Court held that the administrator's interpretation of the plan was not entitled to judicial deference. Rather, the plan should be treated as a contract, and the trial court should construe its terms de novo.

The Supreme Court thus created from trust law a contractual model in which courts engage in de novo review of fiduciary plan interpretations. But the Supreme Court noted in dicta that "neither general principles of trust law nor a concern for impartial decisionmaking . . . forecloses parties from agreeing upon a narrower standard of review."[177] Thus, firms could "contract" for the pre-*Firestone* arbitrary and capricious standard adopted by many courts. Or perhaps it is not really the pre-Firestone arbitrary and capricious standard at all, for the Court cautioned that "if a benefit plan gives discretion to an administrator or fiduciary who is operating under a conflict of interest, that conflict must be weighed as a 'factor in determining whether there is an abuse of discretion.'"[178] Perhaps, then, it is a true trust standard of reasonableness, but only if the firm "bargains" for such a standard by drafting the plan to include language creating discretionary authority in the plan administrator.

Firestone leaves in its wake considerable doctrinal uncertainty. When is a fiduciary laboring under a conflict of interest? Must participants prove that the fiduciary will suffer personal financial harm if it rules in favor of the participant? Or is it sufficient to show that the fiduciary is employed by the plan sponsor? And when does the plan sponsor itself have a conflict? Is there an automatic conflict if the plan is unfunded, as in *Firestone*? Is there a conflict if a plan is funded but the decision will increase the employer's future funding obligations? Is there a conflict if a plan is overfunded and the decision will reduce a potential reversion to the employer? Does the amount of the benefit matter? What about the amount of the benefit relative to the size of the employer? Does it matter if the employer can recover costs by reducing benefits prospectively for other employees?

The questions do not end there. How should a court treat the fact that a fiduciary is operating under a conflict of interest? Should it use a de novo standard of review?[179] Or should it consider the conflict as just one of many factors?[180] Are questions of plan interpretation different from questions of fact?[181] What plan language is sufficient to give a fiduciary discretionary authority over benefits determinations?[182]

177. *Id.* at 115.

178. *Id.* (quoting RESTATEMENT (SECOND) OF TRUSTS § 187 cmt. d).

179. Taylor v. Continental Group Change in Control Severance Pay Plan, 933 F.2d 1227 (3d Cir. 1991); *cf.* Brown v. Blue Cross & Blue Shield of Alabama, Inc., 898 F.2d 1556 (11th Cir. 1990).

180. Bidwell v. Garvey, 943 F.2d 498 (4th Cir. 1991).

181. *See* Pierre v. Connecticut General Life Insurance Co., 932 F.2d 1552 (5th Cir. 1991).

182. *Compare* Masella v. Blue Cross & Blue Shield of Connecticut, Inc., 936 F.2d 98 (2d Cir. 1991) (finding no grant of discretion in general language) *with* Gust, Jr. v. The Coleman Co., 1991 U.S. App.

Professor John H. Langbein has written a thoughtful critique of the Supreme Court's opinion, accusing the Court of inventing a de novo standard of review for trust decisionmaking about issues that are not explicitly characterized as discretionary under the trust instrument.[183] Professor Langbein observes that a trustee's discretion actually is constrained in precisely the opposite manner: the trustee has discretion in exercising powers under the trust except to the extent the trust indenture denies the trustee discretion. Langbein suggests that "the puzzle about *Bruch* is . . . that the Court insisted on deriving [de novo review] from trust law (where it is not the rule) rather than contract law (where it is)."[184]

Ultimately, the answer to the puzzle, and the blame for the analytic quagmire that *Firestone* reflects, is found less in the words of the Supreme Court than in the silence of Congress. In enacting ERISA, Congress failed to answer, or even to frame, the question of what a fiduciary may consider when it interprets a plan. With Congress silent, on what basis should the Supreme Court have determined the appropriate standard of review for a benefit denial? At least in the hands of judges, trust law is sufficiently protean to furnish virtually any answer: the fiduciary's decision should be upheld unless arbitrary and capricious,[185] unless the fiduciary operated under a conflict of interest,[186] unless the court disagrees with the fiduciary's construction of the plan language,[187] or the fiduciary's decision should be upheld only if it can demonstrate that the decision advanced the purpose of providing benefits to employees.[188] But if trust law has failed to guide courts to the appropriate standard of review, neither would have contract law, which can be equally protean.[189] The answer can come only from resolution of the policy questions that Congress left unanswered.

Thus, trust law has not been especially helpful to courts in formulating the appropriate standard of review for benefit denials under ERISA plans. As a result, after eighteen years of experience with ERISA, one of the statute's most complex and recurring questions is not only incompletely unanswered, but is not even properly framed.

Lexis 15203 (10th Cir. 1991) (fiduciary allowed discretion as long as its interpretation does not contradict any stated goals of the plan and complies with the requirements of ERISA).

183. John H. Langbein, *The Supreme Court Flunks Trusts*, 1990 S. CT. REV. 207 (1991).

184. *Id.* at 225-26.

185. RESTATEMENT (SECOND) OF TRUSTS § 187 (discretionary powers subject to control by court only to prevent abuse of trustee's discretion).

186. Two overlapping trust principles might lead to this approach: RESTATEMENT (SECOND) OF TRUSTS § 187 cmt. f, illus. 15, 16 ("court will control the trustee in the exercise of a power where he acts dishonestly").

187. *See* Firestone Tire & Rubber Co v. Bruch, 489 U.S. 101 (1989); but see Langbein, *supra* note 183, for criticism of Supreme Court's application of trust doctrine.

188. RESTATEMENT (SECOND) OF TRUSTS § 170(1) ("trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary").

189. For example, an occasional court notes the rule of *contra proferentum*, construing plans against the employer. *Compare* Eley v. Boeing Co., 945 F.2d 276 (9th Cir. 1991) (applying rule) *with* Wallace v. Firestone Tire & Rubber Co., 882 F.2d 1327 (8th Cir. 1989).

IV

EQUITY AND CONSTRAINTS ON FIDUCIARY SELF-DEALING

Up to this point, this article has argued that ERISA's reliance on equity has furnished courts with an incomplete, sometimes inappropriate framework for resolving issues fundamental to the administration of employee benefit plans. The article now turns to a different problem: the effectiveness of ERISA's trust-like fiduciary standards in preventing fiduciaries from using plan assets to advance their own interests. The exclusive purpose rule, and especially the more particularized prohibited transaction rules, set exacting standards for fiduciary behavior.

ERISA's use of trust law principles to restrain fiduciaries from self-dealing and other conduct detrimental to plan participants has a sound theoretical basis, since ERISA's concern with the use and investment of plan assets closely parallels the concerns of traditional trust law. While the principles underlying traditional trust law may not deal adequately with the types of issues discussed in Part III of this article, they are most assuredly concerned with preventing trustees from self-dealing and other misuse of plan assets. ERISA's resort to trust law principles to restrain fiduciaries from self-interested use of plan assets seems appropriate. But to an extent it also seems irrelevant. An obvious fixture of any regulatory scheme for employee benefit plans is rules buffering plan assets against misappropriation. Congress would have adopted some version of the exclusive purpose rule even if it had not consciously extracted the principles from trust law. The notion that ERISA is a statute regulating people who are entrusted with other people's money makes ERISA an heir to equity; Congress's explicit borrowing from trust law does not.

The success of ERISA in restraining various forms of self-dealing depends less on the formulation of its fiduciary standards than on the probability that those standards will be followed. Although many plan fiduciaries will comply with the statute as a matter of course, others will stray from ERISA's requirements when they perceive the benefits of noncompliance to be greater than the potential costs of noncompliance.

The formulation of a standard for fiduciary behavior is not unrelated to this calculus. Robert Cooter and Bradley Freedman have noted that the trust law duty of loyalty—which they describe as "a cluster of presumptive rules of conduct . . . restrict[ing] the permissible scope of a fiduciary's behavior whenever possible conflicts of interest arise"[190]—increases the probability of trustee rectitude by presuming, often irrefutably, improper use of plan assets when there is a potential for conflict. ERISA's prohibited transaction rules fit this model; they absolutely prohibit commercial and noncommercial dealings between a plan and a party in interest to the plan, unless the dealing is exempted from the

190. Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1053-54 (1991).

rules.[191] A knowledgeable fiduciary who causes a plan to engage in such a transaction knows that if the propriety of a prohibited transaction is litigated, he or she may be left without a legal defense.[192]

But this alone will not ensure a satisfactory level of compliance with the statute.[193] Penalties need to be set sufficiently high to deter fiduciary misconduct after discount for the possibility of nonprosecution.[194] The magnitude of this discount partly reflects the number and skill of parties monitoring fiduciary behavior, and the ease and timeliness with which they can prosecute the civil claims and criminal charges they discover.[195]

A. The Effectiveness of ERISA

In assessing whether the statute has been effective, we are hampered by the absence of any comprehensive empirical studies of fiduciary behavior under the statute. Troubling indications exist, however, that serious compliance problems exist despite the statute's strict rules. While the value of plan assets restored and prohibited transactions reversed through Department of Labor enforcement actions has not been high,[196] the Congressional Research Service has concluded that the Department has failed to monitor pension funds adequately, despite the limited investigative resources of the Department.[197]

One possible problem is the rate of compliance with ERISA's prohibited transaction rules by small employer plans. There are reasons to suspect that

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191. *See supra* notes 24-28 and accompanying text.

192. He or she can, of course, argue that he or she was not a fiduciary, that the party with whom the plan transacted was not a party in interest, or that an exemption was available.

193. I want to consider briefly the level at which compliance might be satisfactory. There obviously is no correct answer. A near-zero level of noncompliance is consistent with ERISA's protective policies, but it would be an expensive undertaking for the Department of Labor, which would have the primary enforcement responsibility, and for plan sponsors who would have to exist with an omnipresent agency constantly monitoring them. Moreover, approaching a zero level of noncompliance would probably require imposing Draconian sanctions on those who breach their responsibilities. The costs of trying to achieve a near-100% compliance level thus might be significant and greatly reduce the willingness of employers to sponsor benefit plans.

On the other hand, ERISA itself seemed driven by anecdotal evidence of specific instances of failure rather than by systemic failure. *See* Ippolito, *supra* note 8, at 15-20. The driving legislative principle behind ERISA seemed to be ridding the barrel of a few rotten apples. Given the magnitude of pain suffered by an elderly person denied promised retirement benefits, this is not necessarily an unreasonable legislative judgment. As a legislative judgment, it suggests even relatively low levels of non compliance might be unacceptable.

194. *Cf.* Cooter & Freedman, *supra* note 190, at 1052-53.

195. The effectiveness of the statute's fiduciary sections partly depends on the degree to which participants are made whole following a breach. This requires that fiduciary breaches are identified while the fiduciary still has the resources to make the participant whole.

196. *See ERISA Enforcement Hearings I*, *supra* note 138, at 107 (prepared statement of Congressional Research Service).

197. *Id.* at 3 (statement of Assistant Secretary of Labor David George Ball, noting no increase in size of staff between 1974 and 1990 and announcing the Department will seek 33% increase in size of investigative staff). The Congressional Research Service indicates that staff has also been hampered by turnover and frequent shifts in policy. The CRS concluded that "the overall consensus seems to be that PWBA has failed to adequately monitor pension funds and is, in fact, overwhelmed by its responsibilities under ERISA." *Id.* at 107.

compliance might be lower than optimal among fiduciaries of such plans. First, the Department of Labor has exempted small plans from ERISA's audit requirements and concentrates its investigations on the plans of large employers.[198] The level of effective monitoring of small plans is thus limited. Second, small business owners who serve as plan trustees generally are unsupervised, and thus are subject to a low or nonexistent degree of internal corporate monitoring. The temptation to "borrow" from a plan thus may go unchecked. Third, the owners of small businesses, as a group, are likely to be less knowledgeable about ERISA's rules than are the specialized managers of the plans of large employers. Fourth, small employers are particularly susceptible to fraudulent practices among unscrupulous service providers, especially with respect to plans providing health insurance.[199]

As noted earlier, little empirical data exists on small employer compliance with ERISA's prohibited transaction rules. However, there is evidence consistent with the existence of such problems. A former Inspector General of the Department of Labor testified before the Senate Subcommittee on Labor that a high degree of fraud is occurring among third-party managers of welfare benefit plans marketed to small employers.[200] Although the Department of Labor targets its investigation primarily on larger plans and service providers,[201] almost half of the few criminal enforcement actions brought in fiscal years 1988 and 1989 were against trustees of small plans or providers of services to small plans, and virtually all of the remaining actions were against negotiated Taft-Hartley plans.[202] The notion that fiduciary breaches are going undetected is also supported by the Department of Labor's decision in fiscal year 1990 to increase, by thirty-three percent, its investigative and enforcement staff.[203] In addition, the director of a respected consumer-oriented pension advocacy group testified before the Senate Labor Committee that Labor Department press releases

> highlight case after case of . . . trustees who have used pension plans as their personal piggy banks. The abuses [include] situations where small business owners have dipped into plans to meet a cash flow crunch, help out a relative, or take advantage of a too-good-to-be-true investment opportunity.[204]

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198. 29 CFR 2520.103-1 (1991).

199. The Assistant Secretary of Labor for the Pension and Welfare Benefits Administration has testified that providers of health services to small employers are often not adequately regulated by the states. *See Dept of Labor's Enforcement of ERISA: Hearing before the Subcomm. on Labor of the Comm. on Labor and Human Resources*, 101st Cong., 2d Sess. 46-49 (1990) [hereinafter *ERISA Enforcement Hearings II*] (comments of Assistant Secretary of Labor David George Ball). An Inspector General of the Department of Labor testified that fraud among providers of health care to small plans has reached intolerable levels. *Id.* at 4.

200. *Id.* at 5.

201. *Id.* at 29 (statement of Assistant Secretary of Labor David George Ball).

202. *See id.* at 78-84 (descriptions of Department of Labor criminal investigations resulting in criminal indictments in 1988 and 1989).

203. *See supra* text accompanying note 197.

204. *ERISA Enforcement Hearings II, supra* note 199, at 109 (statement of Karen Ferguson, Director of Pension Rights Center).

In contrast to fiduciaries of small plans, there are reasons to suspect that fiduciaries of larger plans have a relatively good collective record of compliance with the party-in-interest prohibited transaction rules.[205] Such plans are subject to annual audit.[206] Also, the Department of Labor focuses its investigative resources on large plans.[207] Fiduciaries of such plans—who will usually be employees of the plan sponsor—are likely to be more sophisticated about ERISA; they generally will be aware of the broad scope of the prohibited transaction rules and the personal consequences of violating them. They may also be relatively free from the pressures a principal of a small business might face to use a plan's assets to keep his business viable. The benefits of misuse of plan assets may seem more attenuated to plan managers of a large employer than to owners of small businesses. Large-plan fiduciaries also, generally, have access to legal advice, both to assess whether a transaction is prohibited and to obtain or fit within an exemption from the rules if it is.

The scope of the "party-in-interest" prohibited transaction rules is reasonably well defined. A fiduciary aware of the rules generally can determine if a transaction is proscribed by the rules, at least after consulting with counsel. The choice for such a fiduciary becomes whether to violate the statute.

This is not, however, always the case with respect to ERISA's exclusive purpose and prudence standards, whose requirements are more ambiguous. When the meaning of rules is subject to interpretation, the frequency of fiduciary violations may be high because of the tendency of human beings to resolve uncertain questions to their benefit, unless the probability and harshness of consequences for violations is increased correspondingly.

Section 404(a)(1)(A) requires fiduciaries to discharge their responsibilities solely for the purpose of providing benefits for participants.[208] An unavoidable problem with the exclusive purpose rule arises when the firm has an interest in a fiduciary decision that is either, arguably, not antagonistic to any employee interest or consistent with the interests of a group of employees. All other factors being equal, may the fiduciary select the course of action that harmonizes with the firm's interest? Courts have generally held that fiduciaries do not violate ERISA if they follow "a course of action with respect to the plan which benefits the corporation as well as the beneficiaries."[209] Fiduciaries may take action that "best promote[s] the interest of participants and beneficiaries," even

205. For a description of the prohibited transaction rules, see *supra* notes 24-28 and accompanying text.

206. 29 C.F.R. 2520.103-1(a)(2) (1991).

207. *See supra* text accompanying note 201.

208. The text focuses on ERISA's exclusive purpose rule. Similar problems arise with respect to the prohibited transaction rules under ERISA § 406(b), 29 U.S.C. § 1106(b), which proscribe a fiduciary using plan assets for its own benefit or dealing with the plan on behalf of an adverse party. *See supra* notes 24-26 and accompanying text.

209. Donovan v. Bierwirth, 680 F.2d 263, 270 (2d Cir. 1982).

though such action "incidentally benefits the corporation" that employs the fiduciaries.[210]

In some cases, an incidental benefit test is not especially troubling. For example, in the case of a profit-sharing plan that refuses a lump sum benefit to a former key employee to discourage key employees from leaving and competing with the employer, and thereby reducing firm profits and plan contributions for other employees, the benefit to the plan seems real enough, and the benefit to the employer is coextensive with the benefit to the remaining participants.[211]

In other fiduciary decisions, however, the incidental benefit test seems inappropriate. Often, the fiduciary must take an action that will have such a significant impact on the fiduciary (or the firm that employs the fiduciary) that the fiduciary's judgment is inherently suspect, and the security of benefits is implicated. Unless the probability is high that the fiduciary's actions will be scrutinized closely, and that the penalty for breaching statutory obligations will be harsh, some fiduciaries will act in their own interest to the detriment of plan participants. This seems true for fiduciaries of large and small plans.

B. Fiduciary Decisionmaking: A Troubling Example

The congressional testimony of Howard Gittis, a director of the Coleman Lantern Company, and of Macandrews and Forbes, its parent corporation, provides a revealing glimpse into the thought processes of a fiduciary faced with a course of action that provides immediate benefits to the plan sponsor but has potential future costs to plan participants.[212] The testimony concerned Mr. Gittis's selection of an insurance company to assume the liabilities of a terminating pension plan, a decision that fiduciaries of more than 2000 plans faced during the 1980s.[213]

Regulations of the Pension Benefit Guaranty Corporation require a terminating pension plan to satisfy benefit liabilities by transferring the liabilities to an insurance company.[214] Once the liabilities are transferred, the plan may terminate and distribute all remaining assets to the employer.[215] Because insurance companies charge different premiums, the selection of an insurer

210. *Id.* at 271.

211. *See* Morse v. Stanley, 732 F.2d 1139 (2d Cir. 1984) (upholding decision of plan fiduciary to deny lump sum payment to former plan participant; benefit to employer only incidental). *But see* Frary v. Shorr Paper Products, Inc., 494 F. Supp. 565 (N.D. Ill. 1980) (requiring plan to pay lump sum benefit).

212. *Pension Raiding Risks: Hearings Before the Subcomm. on Labor of the Comm. on Labor and Human Resources*, 101st Cong., 2d Sess. 19 (1990) (testimony of Howard Gittis).

213. In 1984, the legal constraints on terminating overfunding pension plans to recover "surplus" plan assets were liberalized, leading to the termination of more than 2000 plans in which employers recovered at least $1 million in assets. *See generally* Stein, *supra* note 105.

214. 29 C.F.R. §§ 2617.2, 2617.14, 2617.21 (1991).

215. ERISA § 4044(d), 29 U.S.C. § 1344(d). The Department of Labor and PBGC published advanced notices of rulemaking in 1991, requesting information to the public concerning "whether to establish qualitative standards for annuity providers." *See The Effect on Plan Participants of Insurance Company Failures: Hearing Before the Subcomm. on Labor-Management Relations of the Comm. on Education and Labor*, 101st Cong., 1st Sess. 4 (July 25, 1991) [hereinafter *Hearings on Insurance Company Failures*] (statement of Asst. Sec. of Labor David George Ball).

charging a low premium increases the amount of the assets reverting to the employer. Insurance companies are not equal in quality, and different insurance products reflect different levels of risk. Guided by the exclusive purpose rule and the standard of prudence, a plan fiduciary presumably should undertake a process to identify an insurance company of the highest reliability—the issue of concern to participants—and not base decisions on the maximization of asset reversions through entertainment of low bids.[216] A fiduciary with ties to the employer will have a conflict of interest in selecting the insurer if insurers with the greatest claims-paying abilities charge higher premiums than riskier insurers.

Mr. Gittis' testimony[217] concerned MacAndrews & Forbes's acquisition of Coleman Lantern, Coleman's subsequent termination of its pension plan, and the transfer of the plan's liabilities to Executive Life Insurance Co., which, within eighteen months, was insolvent and in state receivership. The decision to use Executive Life was certainly wrong.[218] How did Coleman arrive at this decision?

Mr. Gittis testified that Coleman selected Executive Life through a bidding procedure adopted with the advice of Hewitt Associates, a benefits consulting firm. Twelve major insurance carriers were invited to submit bids. After bids were received, Mr. Gittis "carefully reviewed"[219] the ratings given to each insurer by two insurance ratings services, Standard & Poor's and A.M. Best. One of the twelve bidders was eliminated because its ratings, while investment grade, were relatively low.[220] Executive Life, which at the time of the selection had the highest ratings from the two ratings services, was selected from among the remaining insurers, apparently on the basis of low bid.[221]

No one at Coleman conducted an independent financial analysis of Executive Life,[222] though Mr. Gittis should have been aware that Executive Life's portfolio included large amounts of risky, high-yield debt.[223] No testimony at the hearing suggested that anyone at Coleman sought to learn the process by which Standard & Poor's or A.M. Best determined a company's ratings. Furthermore, no testimony suggested that anyone at Coleman considered retention of a neutral fiduciary to select the annuity provider.

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216. *Hearings on Insurance Company Failures, supra* note 215, at 6 (statement of Asst. Sec. of Labor David George Ball, indicating that a "fiduciary cannot purchase the cheaper, riskier annuity in order to maximize the reversion of excess assets to the employer").

217. *Pension Raiding Risks: Hearings Before the Subcomm. on Labor of the Comm. on Labor and Human Resources*, 101st Cong., 2d Sess. 19 (1990) (testimony of Howard Gittis).

218. The Coleman Lantern story had a happy ending. Mr. Gittis announced at the Senate hearing that the pension plan, which had not yet completed the termination, substituted an annuity contract from a sales insurance company other than Executive Life. *Id.* at 21.

219. *Id.* at 20.

220. *Id.* at 32.

221. *Id.*

222. *Id.* at 35.

223. Mr. Gittis denied knowing that Executive Life held over $300 million in high-yield debt issued by the Revlon Group, Inc., a MacAndrews & Forbes corporation. *Id.* at 33. But he testified that he knew that Executive Life at one point had over $100 million in Revlon securities. *Id.* at 32.

Prior to the completion of the annuity purchase, some California employees of Coleman read negative local news accounts of Executive Life's financial viability.[224] The President of Coleman, Larry Jones, concerned about employee morale, brought these stories to the attention of Mr. Gittis.[225] Mr. Gittis responded to Mr. Jones's concerns by once more checking Executive Life's Standard & Poor's and A.M. Best ratings.[226] After learning that neither Standard & Poor's nor A.M. Best had downgraded the ratings of Executive Life, Mr. Gittis closed on the contract.[227]

This is a rather troubling account of fiduciary decisionmaking. Mr. Gittis, vested with responsibility to choose a safe annuity for the plan participants, limited his assessment of the low-bidding insurance provider to the ratings of two of the principal insurance ratings services after learning from his employees of problems with the provider.

Worse, the selection of Executive Life as annuity provider was probably the single most important fiduciary decision in the life of the plan, which was in the process of transferring all of its benefits liabilities to a single insurance company. To many of the participants in the plan, these liabilities reflected a significant portion of their total wealth. Yet Mr. Gittis, a seasoned businessman experienced in high-stakes corporate acquisitions, with millions of plan dollars available to investigate Executive Life, failed to conduct a meaningful investigation.[228]

The lesson we should draw from this story, which was replayed in several hundred major plan terminations that used Executive Life or other financially stressed insurance companies, is that some fiduciaries, including some who are stewarding the affairs of plans of major corporations, will discharge their obligations to achieve benefits for themselves unless they believe their actions will be closely scrutinized.

The problem here, though, is not that Congress attempted to use equitable precepts to answer questions to which they were not suited. The problem is that fiduciary standards, whether consciously borrowed from equity or not, are not self-enforcing. Without sufficient resources committed to monitoring fiduciary behavior and enforcement of ERISA's fiduciary standards, some fiduciaries will continue to step over the line.

V

CONCLUSION

Congress consciously patterned ERISA after equity's rules for the governance of trusts. Part III of this article argued that Congress's reliance on equity to furnish answers to many common and perplexing issues of benefits policy was

224. *Id.* at 59 (testimony of Larry Jones, President of Coleman Lantern Co.).

225. *Id.* (testimony of Larry Jones).

226. *Id.* at 35 (testimony of Howard Gittis).

227. *Id.* at 21. The third major ratings service, Moody's, had not given Executive Life the imprimatur of its highest ratings.

228. *See supra* note 216 and accompanying text.

misplaced. Part IV, while acknowledging that Congress appropriately used trust standards to regulate fiduciary self-dealing, suggested that Congress may have failed to ensure that these standards would be enforced adequately. This conclusion considers ways in which Congress might "fix" the statute. It also considers the related question of whether an adequate legislative cure exists.

An easy problem to address is the inadequate enforcement of ERISA proscriptions against self-dealing. Congress could take four approaches to improving enforcement: (1) enhance the quality and availability of relevant information about fiduciary behavior; (2) augment the Department of Labor's investigative and prosecutorial resources; (3) provide better incentives for participants to monitor fiduciary conduct and bring suits against defalcating fiduciaries; and (4) increase civil and criminal penalties for breaches of fiduciary duty.

In 1990, the Department of Labor reacted to criticism from consumer groups,[229] the Congressional Research Service,[230] and the Department of Labor's own Inspector General,[231] by delineating the contours of a legislative package that included improvements in each of these areas.[232]

To improve the quality of information, the Department of Labor proposed peer certification of accountants, and expanding the scope of audits to include assets held by banks and other regulated financial institutions.[233] The Department also indicated that it was consulting with the American Institute of Certified Public Accountants concerning the expansion of an accountant's current limited responsibility to report wrongdoing to the Department, but that this was not included in its legislative initiative.[234] In addition, the Department proposed that certain providers of health care services to small employers file a registration statement and that all funded plans disclose how they exercised their franchise on stock holdings.[235]

The Department also asked for a thirty-three percent increase in its investigative and enforcement staff.[236] To encourage participants to bring civil actions against fiduciaries who violate the statute's standards, the Department sought mandatory attorney and expert witness fees for prevailing plaintiffs.[237] The Department further suggested a bounty arrangement, in which it would have discretionary authority to award up to ten percent of any civil recovery to the person who provided the Department with information that led to initiation of

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229. *ERISA Enforcement Hearings II, supra* note 199, at 108 (statement of Karen Ferguson on behalf of Pension Rights Center).

230. *See supra* note 197 and accompanying text.

231. *ERISA Enforcement Hearings II, supra* note 199, at 4 (statement of Acting Inspector General, U.S. Dept. of Labor, Raymond Maria).

232. *ERISA Enforcement Hearings I, supra* note 138, at 2-8 (testimony of Asst. Sec. of Labor David George Ball).

233. *Id.* at 5.

234. *Id.* at 7-8.

235. *Id.* at 6-7.

236. *Id.* at 3.

237. *Id.* at 5.

the investigation.[238] Finally, the Department supported increases in civil penalties against fiduciaries who enter prohibited transactions.[239]

Consumer groups generally reacted positively to the Department of Labor's proposals, contending that they were a positive "first" step.[240] The proposals did not, however, address some concerns about inadequate disclosure, including the limited disclosure requirements applicable to small plans.[241]

In 1991, the Department backtracked from its own limited proposals.[242] Reacting to concern in the business community about the proposals' costs,[243] the Department concluded that the proposals (other than the increase in staff) were unnecessary.

The tensions that prompted the Department first to propose a modest legislative package to improve enforcement and then to withdraw it reflect a set of recurring themes in government regulation of employee benefits. One of ERISA's stated purposes is the protection of employee interests in benefit plans,[244] a goal that justifies the elaborate layers of associated federal regulation. However, the legislative history of ERISA is peppered with reference to a second government goal: encouraging the growth of employee benefit plans through the provision of tax incentives for employers to establish such plans.[245]

These notions of regulation and encouragement are not entirely compatible. The greater the degree of regulation of plans, the greater the direct and indirect costs to the plan sponsor.[246] The greater these costs, the lower the size of benefits and the rate of plan formation. The business community and organized labor can thus argue against increasing the enforcement of ERISA's fiduciary standards within the legitimate framework of benefits policy debate. Their argument is that too much protection for employees will result in fewer plans and lower benefits.

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238. *Id.* at 5-6.

239. *Id.* at 6.

240. *Id.* at 41 (testimony of Dennis Crites on behalf of AARP); *id.* at 44 (statement of Vicki Gottlich on behalf of National Senior Citizen's Law Center); *id.* at 52 (statement of Jeffrey Lewis on behalf of National Employment Lawyers Association). Each of the groups testifying criticized the Department's proposals for not sufficiently helping employees with individual benefit disputes.

241. *ERISA Enforcement Hearings II, supra* note 199, at 108 (statement of Karen Ferguson on behalf of Pension Rights Center). The Department's proposals also failed to address the Pension Rights Center's concern that plans are currently permitted to retain the same accountant as the employer. *Id.*

242. Frank Greve, *Heat is on U.S. Pension Watchdog*, PHILA. INQUIRER, Feb. 2, 1991, at C-1.

243. David George Ball, Assistant Labor Secretary, indicated that the pension industry likened the reform proposals to "dropping a nuclear bomb on the administration of pension benefits." Greve, *supra* note 242 at C-2. Ball also said that "we must undertake our regulatory responsibilities in a manner which does not interfere with the marketplace."

244. ERISA § 2(b), 29 U.S.C. § 1001(b).

245. *See, e.g.*, 119 CONG. REC. 30,010 (1973) (comments of Senator Ribicoff: "[T]he Federal Government is already heavily involved in the private pension system. The tremendous growth of the private programs has been possible only through the use of Federal tax incentives.").

246. *See, e.g.*, *id.* at 30,046 (comments of Senator Curtis: "[I]n setting minimum standards for pension plans, account must be taken of the fact that whether the pension plan is set up in the first place or not is a voluntary action on the part of the employer. Because of this, the standards must not be set so high as to discourage the formation of private pension plans.").

Similar tensions discussed in Part III of this article are not satisfactorily resolved through traditional equitable norms. Should federal law permit plans to sacrifice optimal investment return in exchange for other participant benefits? Should it allow employers to reserve the right to interpret ambiguous plan provisions? Should it bar awards of extracontractual damages? Should it refuse to enforce oral modifications of written plans? Should it prohibit jury trials? Affirmative answers to such questions contribute to plan formation by reducing costs and/or by increasing the autonomy of labor and management to create employee benefit programs that meet particular workplace needs, as they conceive them. On the other hand, affirmative answers also reduce the security of individual employees in their health and retirement benefit expectations.

The resolution of this policy bipolarity in the context of each of these questions requires legislative consideration. Congress failed, in ERISA, to address the questions directly, leaving their resolution to the federal courts with equity as a primary guide. Equity, however, is an incomplete framework for resolving the benefits policy issues of the sort raised in this article. Moreover, courts, confronting issues only in the context of individual cases, lack a broad policy perspective and are confined to the evidence and arguments placed before them by advocates. They seem poorly suited to balance the competing policies discussed in this article.

If there is a prescription for ERISA reform, then, it is for Congress to reconsider particular benefits issues and furnish specific answers to them. This is a difficult undertaking because of the fundamentally contradictory policies undergirding the statute. Reliance on a voluntary, regulated system, then, may be the wrong approach if the government is serious about providing retirement and health benefits to working men and women. The alternative is either a system of mandated employer provision of benefits[247] or an expanded government role along the lines of a funded social security system. But those are other stories.

247. *See generally* Bruce Wolk, *Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality*, 70 VA. L. REV. 419 (1984).