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FREEDOM TO CHOOSE UNWISELY: CONGRESS' MISGUIDED DECISION TO LEAVE 401(K) PLAN PARTICIPANTS TO THEIR OWN DEVICES

Susan J. Stabile†

INTRODUCTION

As recently as twenty years ago, the primary means of providing retirement income to employees was the traditional defined benefit pension plan, in which qualified professionals subject to fiduciary standards of prudence and diversification make investment decisions.¹ However, employers increasingly provide retirement benefits for their employees through participant-directed 401(k) plans.² In such plans, individual plan participants with no specialized investment knowledge make all major decisions subject to no standards whatsoever.³ These decisions include

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¹ Section 404 of ERISA defines the duties of fiduciaries of plans. Of most relevance to investment of plan assets are the statutory duties of prudence and diversification. 29 U.S.C. § 1104(a)(1)(B)–(C) (1994). Section 404 also requires plan fiduciaries act in the best interest of plan participants and act in accordance with plan documents. 29 U.S.C. § 1104(a)(1)(A), (D) (1994). In addition, section 406 of ERISA prohibits a fiduciary from engaging in certain transactions between the plan and a party in interest. Prohibited transactions include sales or exchanges of property or the lending of money. 29 U.S.C. § 1106(a)(1)(A)–(B) (1994). A fiduciary is also prohibited from managing assets of the plan for his own interest and from dealing with any party whose interests are adverse to those of the plan. 29 U.S.C. § 1106(b)(1)–(2) (1994).

² See MAYA KROUMOVA, INVESTMENT IN EMPLOYER STOCK THROUGH 401(K) PLANS: IS THERE REASON FOR CONCERN 18 (2001) (noting the bulk of net increase in defined contribution plans came from 401(k) plans); Jack L. VanDerhei, *Company Stock in 401(k) Plans: Results of a Survey of ISCEBS Members*, EBRI SPECIAL REPORT, Jan. 28, 2002, at 2 (401(k) plans account for 48% of active employees and 65% of new plan contributions); *Advisory Council: Looming National Retirement Crisis to Confront Baby Boomers, Speaker Says*, 28 PENS. & BEN. REP. (BNA) 2599-2600 (Oct. 23, 2001) (noting the growth in defined contribution plans "can be primarily attributed to the explosion in tax code Section 401(k) plans"); Sarah Holden & Jack VanDerhei, *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 1999*, 230 EBRI ISSUE BRIEF 7 (Feb. 2001) (noting almost 40 million employees now participate in 401(k) plans).

³ Participant direction of investments is not an inherent feature of 401(k) plans and there are employers who sponsor 401(k) plans in which the employer, or another fiduciary appointed

whether and how much to contribute to the plan, and how to invest plan contributions.

The primary federal statute regulating pension plans, the Employee Retirement Income Security Act of 1974 ("ERISA"),⁴ was drafted with the defined benefit pension plan in mind. This is not surprising considering ERISA was enacted when the pension landscape was dominated by such plans and 401(k) plans did not even exist.⁵

ERISA designates anyone exercising any control over pension plan assets as a fiduciary,⁶ and imposes on fiduciaries the responsibility to operate under a set of exacting standards,⁷ with the threat of liability for any losses incurred by a failure to live up to those standards.⁸ In addition, it imposes co-fiduciary liability for any losses on any other fiduciary who participates in or enables a breach by another fiduciary.⁹

ERISA specifically provides, however, in plans permitting participants to exercise control over the assets in their own individual accounts, (1) a participant is not deemed to be a fiduciary by reason of the exercise of such control, and (2) no other fiduciary has any liability for any loss, or by reason of any breach, resulting from such exercise of control.¹⁰ Although this provision of ERISA was not drafted with 401(k) plans in mind,¹¹ if a 401(k) plan and its operation satisfy Department of Labor

by the employer, makes decisions regarding investments of plan contributions. The vast majority of 401(k) plans, however, feature participant direction of investments. See Jayne Elizabeth Zanglein, *Investment Without Education: The Disparate Impact on Women and Minorities in Self-Directed Defined Contribution Plans*, 5 EMPLOYEE RTS. & EMP. POL'Y J. 223, 248 (2001) (in 1997, 87% of defined contribution plan participants directed the investment of their own contributions and 65% invested employer contributions); PENSION AND WELFARE BENEFITS ADMIN., U.S. DEP'T OF LABOR, PRIVATE PENSION PLAN BULLETIN No. 10, ABSTRACT OF 1997 FORM 5500 ANNUAL REPORTS (2001), available at www.dol.gov/dol/pwba/public/programs/opr/bullet97 (reporting 78% of 401(k) plans, covering 83% of active plan participants, provide for participant direction).

⁴ 29 U.S.C. §§ 1001-1461 (1994). In addition to the fiduciary provisions discussed in the text, ERISA imposes on most pension plans of private employers minimum requirements in areas such as vesting, benefit accrual and funding. 29 U.S.C. §§ 1053-1086 (1994). It also regulates plan termination. 29 U.S.C. §§ 1301-1371 (1994). In addition, the statute creates causes of action that are the sole means for obtaining relief for violations of the provisions of the statute. 29 U.S.C. §§ 1131, 1144(a) (1994).

⁵ Amendments to the Internal Revenue Code enacted in 1978 allowed for the creation of 401(k) plans. See Revenue Act of 1978, Pub. L. No. 95-600, § 135, 92 Stat. 2763 (1978) (codified as amended at 26 U.S.C. § 401(k)).

⁶ 29 U.S.C. § 1002(21)(A) (1994). A person is also a fiduciary for purposes of ERISA if the person provides investment advice regarding the investment of plan assets. 29 U.S.C. § 1002(21)(A)(ii) (1994); 29 C.F.R. § 2510.3-21(c) (2001).

⁷ See generally *supra* note 1.

⁸ 29 U.S.C. § 1109(a) (1994).

⁹ 29 U.S.C. § 1105(a) (1994).

¹⁰ 29 U.S.C. § 1104(c) (1994).

¹¹ As already noted, 401(k) plans did not exist at the time ERISA was enacted. Instead, thrift or savings plans existed allowing for after-tax employee contributions made through payroll deductions. Since such plans supplemented employer-provided defined benefit plans

("DOL") regulations regarding "control,"¹² the participant making investment decisions is not a fiduciary, and therefore not subject to any standards, and will not be able to hold any other fiduciary liable for any losses incurred by the participant's investment decisions.

The failure of adapting ERISA to the changing pension landscape creates an enormous risk that 401(k) plan participants will retire with vastly inadequate funds to support them during their retirement.¹³ The statutory scheme overestimates the ability of participants to protect themselves. Operation of various cognitive biases render plan participants incapable of acting in their own self-interest in making plan investment decisions.¹⁴ Furthermore, the operation of section 404(c) potentially immunizes employer contributions to poor employee decision-making, thus permitting employer opportunism.¹⁵ The risk here is not merely a problem for the individual retirees. Rather, it is in our societal interest to ensure employees will retire with adequate income security.¹⁶ The risk that they will not has given rise to numerous suggestions regarding how to influence or mandate certain employee choices.¹⁷ An alternative to establishing specific rules regarding participant decisions would be imposing standards, i.e. to reconsider the Congressional decision to remove participant decisions from the realm of fiduciary standards.¹⁸

and were not the primary means of providing retirement income to employees, Congress was perhaps not particularly concerned with the consequences of participant investment decisions in such plans.

¹² Section 404(c) of ERISA speaks of exercising control "as determined under regulations of the Secretary of [Labor]." In 1992, the DOL implemented final regulations specifying what it means for a participant to exercise control for purposes of section 404(c). See Final Regulations Regarding Participant-Directed Individual Account Plans, 57 Fed. Reg. 46,906 (Oct. 13, 1992) (codified at 29 C.F.R. pt. 2550).

¹³ See Jack VanDerhei & Craig Copeland, *The Changing Face of Private Retirement Plans*, 232 EBRI ISSUE BRIEF 3 (Apr. 2001) (describing the question whether future retirees will have adequate retirement incomes as a "rapidly growing public policy concern facing the United States").

¹⁴ See *infra* text accompanying notes 159-169. How to invest plan contributions is not the only decision plan participants need to make in 401(k) plans. They also decide whether to participate in the program in the first place, and how much of their income to contribute to the plan. In addition, participants who change jobs during their working lives must decide what to do with their 401(k) plan account balance when they leave their old employer. Poor decisions in each of these areas also contribute to the danger that employees will retire with inadequate retirement income. I have discussed these other decisions elsewhere. See Susan J. Stabile, *The Behavior of Defined Contribution Plan Participants*, 77 N.Y.U. L. Rev. 71, 80-86, 95-98 (2002). The justifications for legal intervention in the investment context that I explore in this Article apply as well to those other areas.

¹⁵ See *infra* text accompanying notes 78-87.

¹⁶ See *infra* text accompanying notes 176-180.

¹⁷ See *infra* text accompanying notes 187-191.

¹⁸ There are other alternatives, for example, mandating employers provide participants with education regarding investments. I express my concerns with the efficacy of education later, but do agree that employers could be doing more than they currently are in that regard.

This Article, drawing on two theoretical perspectives, develops a new way of contemplating the regulation of 401(k) plans. First, it utilizes the findings of behavioral theorists regarding context-dependence. The effect of context-dependence is that “control,” which is the theoretical predicate for removing participant decisions from the fiduciary realm, is illusory. Despite the fact that 401(k) plan participants make their own investment decisions, the actual choices presented and how those choices are presented has a tremendous impact on participant decision-making.¹⁹ Thus, significant control remains in the hands of the employer and other fiduciaries participating in plan administration. As a result, behavioral theory forces us to explore the question whether ERISA inappropriately removes participant decisions from the realm of fiduciary standards, which as a practical matter, also raises the question whether employers should be taken off the hook for losses suffered by 401(k) plan participants’ investment decisions.

Second, the Article argues that a fundamental distinction exists between the current contributor to a 401(k) plan and the future beneficiary of the plan’s assets. Retirement presents such a fundamental change in circumstances that, although we are dealing with the same person, the interests between the current contributor and the future beneficiary are vastly different.²⁰ Thus, control by the former does not equate to meaningful control by the latter, for whose benefit ERISA was enacted. This distinction is important because interference with 401(k) plan participant decisions appears, on its face, to involve legal intervention in an area within the realm of individual choice. It is necessary to ask whether it is appropriate for the law to intervene in participant plan decisions given our presumption that the law should not interfere with private choices and that interference must be justified as an exception to the general rule. Once one recognizes the separation of interests between the current contributor and the future retiree, it is easy to justify for regulation of the former to protect the interests of the latter.

The Article begins with an examination of section 404(c) of ERISA, which is the provision that removes participant 401(k) plan decisions from the fiduciary realm. Part I examines the theory and purpose of section 404(c), and Part II outlines the statutory and regulatory requirements for removing 401(k) plan investment decisions from the reach of ERISA’s fiduciary standards and liability. The next two sections evaluate Congress’ determination that participants’ control over their 401(k) plan accounts justifies giving them complete freedom and responsibility for their 401(k) plan choices. Part III presents the two theoretical perspectives earlier alluded to in considering whether participants really exercise

¹⁹ See *infra* text accompanying notes 88-136.

²⁰ See *infra* text accompanying notes 137-157.

meaningful control over their 401(k) plan account balances. It concludes that 401(k) plans offer only an illusion of control to the current contributors and no control at all to the future plan beneficiaries. Part IV questions the Congressional judgment embodied in section 404(c), suggesting that there are reasons for the law to adopt a more paternalistic stance in this area even if participants do, in fact, exercise meaningful control over their individual plan accounts. Parts III and IV thus question both Congress' decision to immunize employers for participant decisions in 401(k) plans and its decision that participants are free to make whatever decisions they choose, subject to no standards whatsoever. Finally, Part V of the Article raises issues requiring consideration in order to determine what form legal intervention might take to increase the likelihood 401(k) plan participants will have sufficient income security during their retirement. It also draws on the findings of behavioral theorists, suggesting employers establish default investment options for plan participants.

I. PURPOSE AND THEORY OF 404(C)

Theoretically, a participant directing the investment of her 401(k) plan account balance is, by statutory definition, a fiduciary.²¹ Of more practical significance, the employer sponsoring the 401(k) plan and responsible for its selection of investment options and operation is *theoretically* a co-fiduciary, facing potential liability for any loss resulting from the participant's failure to satisfy ERISA's fiduciary standards with respect to investing her account balance.²²

These statements are theoretical only, however, owing to the operation of section 404(c) of ERISA. Section 404(c) provides that in the case of a plan that

provides for individual accounts and permits a participant or beneficiary to exercise control over the assets in his account, if a participant or beneficiary exercises control over the assets in his account (as determined under regulations of the Secretary [of Labor]) [then] (A) such participant or beneficiary shall not be deemed to be a fiduciary by reason of such exercise, and (B) no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which re-

²¹ See 29 U.S.C. § 1002(21)(A)(i) (1994) (designating as a fiduciary those with authority over pension plan assets).

²² See 29 U.S.C. § 1105(a) (1994).

sults from such participant's or beneficiary's exercise of control.²³

In 1992, the DOL implemented final regulations specifying what it means for a participant to exercise control for purposes of section 404(c).²⁴

A 401(k) plan provides for individual accounts,²⁵ meaning that if a plan and its operation satisfy DOL regulations, then the participant making investment decisions falls under 404(c) and is not a fiduciary while the employer faces no liability for any losses caused by the participant's exercise of control. Since the DOL regulations passed in 1992, large numbers of employers have restructured their 401(k) plans in an effort to achieve precisely this result.²⁶

To fully understand section 404(c) and its place in ERISA, it is necessary to appreciate the historical underpinnings of the statute itself. ERISA was enacted to address perceived abuses by employers who sponsor pension plans.²⁷ Like many labor and employment laws, ERISA's justification for interfering in private contractual dealings over pensions was the need to protect employees from employer overreaching, i.e., to protect a party with weaker bargaining power from fraud and opportunistic behavior by a party with superior bargaining power.²⁸ The statute was passed amid concern of employees not receiving pension benefits promised to them due to inadequate vesting provisions, failure of employers to adequately fund plans and, indeed, outright theft of pension fund as-

²³ 29 U.S.C. § 1104(c) (1994) (amended 1996). Ironically, the statute essentially says that if a participant does what a fiduciary would normally do in a defined benefit plan (i.e. invest plan assets), then the participant is not a fiduciary and no one else has any liability for the consequences of the participant's decisions.

²⁴ Final Regulation Regarding Participant Directed Individual Account Plans (ERISA Section 404(c) Plans), 57 Fed. Reg. 46,906 (Oct. 13, 1992) (to be codified at 29 C.F.R. pt. 2550). See also *infra* text accompanying notes 57-87.

²⁵ 29 U.S.C. § 1002(34) (1994).

²⁶ See Colleen E. Medill, *Stock Market Volatility and 401(k) Plans*, 34 U. MICH. J.L. REFORM 469, 478-79 (2001) (discussing changes in plans since enactment of final 404(c) regulations).

²⁷ One example is the Fair Labor Standards Act, enacted to address "labor conditions detrimental to the maintenance of the minimum standard of living necessary for health, efficiency, and general well-being of workers." 29 U.S.C. § 202 (1994). See JULIUS G. GETMAN ET AL., *LABOR MANAGEMENT RELATIONS AND THE LAW* 1-2 (2d ed. 1999) (describing historical background to modern labor law and noting the need for law to address the economic power of employers); Clyde W. Summers, *Labor Law as the Century Turns: A Changing of the Guard*, 67 NEB. L. REV. 7, 7 (1988) (noting common justification for immutable employment laws that individual workers lack the bargaining power necessary to protect their own interests).

²⁸ Not everyone agrees that this is a sufficient basis for legislation. See, e.g., Stewart J. Schwab, *Predicting the Future of Employment Law: Reflecting or Refracting Market Forces?*, 76 IND. L.J. 29, 47 (2001) ("unequal bargaining power is not a market failure" and "unequal bargaining power is not a good reason for intervening in labor markets").

sets.²⁹ Although ERISA does not require employers to provide pensions to their employees, it does require employers to adhere to a set of rules designed to ensure promises by employers are fulfilled.³⁰

As a result, most ERISA provisions reflect an obvious desire to protect employees from employer abuse.³¹ For example, the statute establishes minimum design standards in areas such as vesting, benefit accrual, and funding,³² and establishes a comprehensive set of rules regarding plan termination.³³ It also contains reporting and disclosure provisions designed to ensure that employees have a clear understanding of their rights under the plan and that the DOL has a basis for oversight.³⁴ Perhaps even more importantly, the statute subjects employers and others involved in the administration and management of plans and plan assets to a stringent set of fiduciary standards and prohibitions against certain transactions.³⁵ Fiduciary rules prohibiting a defined benefit plan³⁶ from holding employer securities in excess of a certain percentage of the plan's assets illustrates the focus on employer abuse. The law currently imposes no similar limit in the case of participant-directed plans, which are permitted to hold as much as 100% of their assets in employer securities.³⁷ This same concern with protecting employees from employer

²⁹ See S. REP. NO. 93-383, at 2-4 (1973), reprinted in 1973 U.S.C.C.A.N. 4889, 4891-4892. See also Corey J. Ayling, *New Developments in ERISA Preemption and Judicial Oversight of Managed Care*, 31 CREIGHTON L. REV. 403, 406 (1998) (noting that "Congress was concerned about inadequate funding of employee benefit plans and the resulting hardship to employees who had relied on anticipated benefits and who were left with an inadequate remedy"); Frank P. Vanderploeg, *Role-Playing Under ERISA: The Company as "Employer" and "Fiduciary,"* 9 DEPAUL BUS. L.J. 259, 263 (1997) (purpose of ERISA was to "address the perceived problem that employers reduced wages in exchange for pension and other benefits, and then failed to honor those promises").

³⁰ See generally *supra* note 4.

³¹ That is not to say there are no provisions of ERISA directed at protecting the employee against herself. An example of one such provision is ERISA's rule against alienation of pension benefits. 29 U.S.C. § 1056(d)(1) (1994). However, such provisions are the exception rather than the rule. In contrast, many of the Internal Revenue Code provisions regarding pensions are more paternalistic in their aim. See *infra* notes 173-175 and accompanying text.

³² 29 U.S.C. §§ 1053-1086 (1994).

³³ 29 U.S.C. §§ 1301-1371 (1994).

³⁴ 29 U.S.C. §§ 1021-1031 (1994).

³⁵ 29 U.S.C. §§ 1002(21)(A), 1104, 1106 (1994).

³⁶ See *infra* note 49.

³⁷ 29 U.S.C. §§ 1107(a)(2), (b)(2) (1994). I have previously argued that the failure to impose limits on acquisitions on employer securities by participant-directed plans is problematic. See Susan J. Stabile, *Pension Plan Investments in Employer Securities: More is Not Always Better*, 15 YALE J. ON REG. 61 (1998). As a result of highly publicized failures of companies like Enron, recently introduced legislation propose to limit the acquisition of employer securities by participant-directed plans. See Pension Protection and Diversification Act of 2001, S. 1838, 107th Cong. (2001) (providing accounts of participants in participant-directed plans may invest no more than 20% of their assets in employer securities).

abuse is visible in most of the major changes made to ERISA over the years.³⁸

Section 404(c)'s exemption from ERISA's fiduciary standards of individual plan participants' investment decisions is understandable as a provision drafted by a Congress concerned with employer abuse. Indeed, acknowledging a primary focus on employer abuse is the only way to understand section 404(c). Section 404(c) has two effects: first, it frees participants making plan decisions from standards imposed if a fiduciary were making the same decisions; second, it removes employer liability for any losses suffered by a participant's exercise of control over her plan account assets. Each will be addressed in turn.

A. PARTICIPANT IS NOT SUBJECT TO FIDUCIARY STANDARDS

From a pure investment theory point of view, standards of prudence and diversification are no less important in participant-directed plans than in plans where the employer or a fiduciary appointed by the employer makes investment decisions. Once one acknowledges the primary purpose of fiduciary provisions is to protect participants from employer abuse, it becomes understandable that the provisions do not apply in the case of participant-directed 401(k) plans.

The unstated corollary of the observation that the law in this area is intended to protect employees against employers is that the law is *not* intended to protect employees from themselves. Section 404(c) embodies the congressional judgment that when individuals make decisions regarding their own retirement assets, the responsibility for those decisions lies solely with the individual. This reflects an acceptance of a model of individual liberty, and a presumption that the law ought not interfere with private choices primarily affecting the individual making those choices.³⁹

³⁸ See, e.g., Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, 110 Stat. 1936 (1996) (amending ERISA to impose certain portability requirements on employer-provided health insurance, limiting the application of preexisting condition exclusions to individuals who change jobs); Retirement Protection Act of 1994, Pub. L. No. 103-465, 108 Stat. 4809 (1994) (amending ERISA to require greater funding for under-funded plans and to place new limits on the range of interest rate and mortality assumptions used in establishing funding targets); Age Discrimination in Employment Amendments of 1986, Pub. L. No. 99-592, 100 Stat. 3342 (1986) (making it unlawful for employers who maintain defined benefit plans to cease an employee's benefit accrual or reducing the rate of such benefit accrual because of age); Single Employer Pension Plan Amendments Act of 1986, Pub. L. No. 99-272, 100 Stat. 237 (1986) (amending Title IV of ERISA to protect the PBGC insurance system from employer abuse by restricting certain terminations of under-funded plans); Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. No. 99-272, 100 Stat. 82 (1986) (amending ERISA to require that the sponsor of a group health plan make continuation coverage available to certain medical plan beneficiaries who lose coverage upon the occurrence of certain events).

³⁹ I later argue that the premise of this assumption is faulty and society, in fact, has an interest in these participant decisions. See *infra* text accompanying notes 176-180.

This model is consistent with our general acceptance of the notion that an individual has an absolute right to engage in conduct causing no harm to others.⁴⁰ The model objects to legal interference with private decisions as violations of a liberty interest.⁴¹

Section 404(c) also reflects the current emphasis on consumer sovereignty and individuals having different retirement needs and goals (based on differences in factors such as age, health and other financial resources).⁴² Because of those differences, participants are viewed as being in a better position than employers or the government to evaluate how various plan choices (participation levels, investment of account balances, etc.) serve those interests and desires.⁴³ The model presumes the plan participant as a rational decision-maker. A rational decision-maker (the participant), faced with a diverse set of investment choices, is capable of acting in a manner maximizing her rational self-interest.⁴⁴ The law need not impose standards to tell her to act in her own self-interest.

B. EMPLOYER IS NOT A CO-FIDUCIARY

As a practical matter, the real significance of section 404(c) was freeing employers from potential fiduciary liability for decisions made by plan participants.⁴⁵ The justification for taking the employer off the

⁴⁰ See JOHN STUART MILL, *ON LIBERTY* 73-74 (Hackett Publishing 1978) (1859) (society has no jurisdiction in situations "when a person's conduct affects the interests of no persons besides himself . . . In all such cases, there should be perfect freedom, legal and social, to do the action and stand the consequences").

⁴¹ See Cass R. Sunstein, *Legal Interference with Private Preferences*, 53 U. CHI. L. REV. 1129, 1131-32 (1986) (discussing objection to legal interference with private choices based on liberty, the idea "that the government ought not, at least as a general rule, to be in the business of evaluating whether a person's choice will serve his or her interests, or even whether the choice is objectionable, except where the choice causes harm to others").

⁴² Indeed, part of the popularity of 401(k) plans stems from the fact that "they fit in perfectly with traditional notions of self-reliance and rugged individualism." Karen W. Ferguson, *Rewriting the Rules on Retirement: How 401(k)'s Hurt Lower-Paid Workers*, N.Y. TIMES, Apr. 27, 1986, at C2.

⁴³ The notion has been expressed during Congressional hearings held in the wake of Enron's collapse. See *Hearing on Employee and Employer Views on Retirement Security Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 107th Cong. (March 5, 2002) (testimony of James A. Klein, President, American Benefits Council), available at <http://waysandmeans.house.gov/oversite/107cong/3-5-02/3-5klein.htm>.

⁴⁴ See Christine Jolls et al., *A Behavioral Approach to Law and Economics*, in BEHAVIORAL LAW AND ECONOMICS 13-14 (Cass R. Sunstein ed., 2000) describing Gary Becker's formulation of basic principles of law and economics.

⁴⁵ As a practical matter, no enforcement consequences will flow from the employee's being a fiduciary except insofar as there is co-fiduciary liability on the part of the employer. The employee is not going to sue herself for a breach of fiduciary duty and the DOL is not likely to bring action either. Thus, the only practical consequence of § 404(c) is to free employers from co-fiduciary liability. Freeing employers from such liability obviously encourages participant-direction of plan. See, e.g., Coleen E. Medill, *The Individual Responsibility*

hook in participant-directed 401(k) plans is the fact that it is the participant who exercises control over investment decisions.⁴⁶ Again, we posit the participant as a rational actor capable of making decisions in her rational self-interest. If, in fact, the participant exercises control, then the cause of any loss is the participant's action. If the employer has established a plan meeting section 404(c)'s requirements, then the employer has not participated in or enabled any fiduciary breach (more precisely, what would be labeled a breach if the participant were subject to fiduciary standards).⁴⁷ Therefore, there is no justification for forcing the employer to bear the consequences of the participant's decisions.

I said before that section 404(c) is an understandable provision in a statute primarily concerned with employer opportunism. ERISA's focus on employer opportunism made sense given the pension landscape as it existed at the time the statute was passed.⁴⁸ In 1974, the predominant means of providing pension benefits was the defined benefit pension

Model of Retirement Plans Today: Conforming ERISA Policy to Reality, 49 EMORY L.J. 1, 46 (2000) (observing that the § 404(c) regulations encourage employers to allow participant direction by removing the concern with investment liability). It is a separate question whether encouraging participant-direction is a good idea. The problems with participants decision-making discussed below, *see infra* notes 159–170 and accompanying text, cast serious doubt that it is, notwithstanding the fact many participants enjoy making their own investment decisions. *See, e.g.*, Medill, *supra* note 45, at 19 (citing EBRI survey finding that 62% of respondent plan participants prefer making their own investment decisions).

Although § 404(c) does not relieve fiduciaries from their obligations under § 404(a), it does minimize the sphere in which those duties operate, possibly rendering them virtually meaningless in plans satisfying the regulations. *See infra* text accompanying notes 78–85.

⁴⁶ This is the reason that § 404(c) protection only extends to the portion of a participant's account that the participant actually controls. So, for example, if a plan provides participants directing the investment of their own contributions, but employer matching contributions are automatically invested in an employer stock fund, § 404(c) does not cover the employer matching contributions.

⁴⁷ The statute did not have to be drafted this way. Section 404(c) could have provided that the employer's actions be tested against the standards set out in § 405, the statutory section establishing co-fiduciary liability. *See* 29 U.S.C. § 1105(a) (1994). Presumably Congress took the logical approach that if participants were not fiduciaries, employers should not be subject to co-fiduciary standards. If § 405 were the standard applied, there would be a potential for co-fiduciary liability for losses occasioned by participants' investment decisions. Section 405 imposes co-fiduciary liability in three scenarios: (1) where a fiduciary knowingly participates or knowingly conceals the breach of another fiduciary; (2) where a fiduciary's own failure enables another fiduciary to commit a breach; and (3) where a fiduciary has knowledge of a breach by another fiduciary but makes no attempt to remedy the breach. *Id.* While it is clear there would be no employer liability under the first prong, and there would unlikely be liability under the second, courts might very well find a violation of the third prong given the statute requires affirmative steps to try to remedy a breach.

⁴⁸ The focus on employer opportunism also made sense because the rise of pensions (and the passage of ERISA itself) occurred during a time when the dominant assumption of labor and employment law was of a lifetime model of employment. Under a lifetime model of employment, there are different points in the cycle where there are different risks of opportunistic behavior by employers. *See* Ian Ayres & Stewart Schwab, *The Employment Contract*, 8 KAN. J.L. & PUB. POL'Y. 71 (1999) (discussing problems of asymmetric performance that arise over a career life-cycle); Stewart J. Schwab, *Life-Cycle Justice: Accommodating Just Cause*

plan, a plan reflecting a promise and action only by the employer. The employer decided what pension benefit would be provided⁴⁹ and determined which of its employees could participate in (i.e., receive benefits from) the plan. The employer contributed to the plan to fund those benefits in accordance with funding rules and regulations established under ERISA.⁵⁰ The employer or an agent of the employer undertook investment of plan assets and it was the employer who bore the risk of loss on those investments. Very little in terms of decision-making or action was required on the part of the employee.⁵¹

However, the pension landscape today is vastly different from what it was in 1974. Employers have moved away from a defined benefit plan universe to provide benefits predominantly through defined contribution plans such as 401(k) plans.⁵² It is thus appropriate to question whether protection against employer abuse ought to continue to be the Holy Grail.

and Employment at Will, 92 MICH. L. REV. 8 (1993) (discussing opportunism existing in a career employment relationship).

More recent legislative enactments in the labor and employment area reflect a change from the lifetime model. See, e.g., Health Insurance Portability and Accountability Act of 1996, Pub. Law No. 104-191, 110 Stat. 1936 (1996) (amending ERISA to impose portability requirements upon employer-provided and other health insurance); Consolidated Omnibus Budget Amendment Act of 1985, Pub. Law No. 99-272, 100 Stat. 82 (1986) (requiring that sponsors of group health plans make continuation health coverage available to certain employees and their beneficiaries who lose medical coverage upon the occurrence of certain events, including termination of employment).

⁴⁹ In a defined benefit plan, participants receive an annual pension benefit, the amount of which is determined by a formula contained in the plan. See 29 U.S.C. § 1002(35) (1994). For example, an employer might promise a participant receiving an annual pension benefit commencing at normal retirement age equal to a percentage of their final salary times the participant's years of service.

⁵⁰ See 29 U.S.C. § 1082 (1994) (establishing minimum funding standards for plans); Treas. Reg. § 1.412 (b), (c) (as amended in 1981) (elucidating the statutory funding requirements).

⁵¹ The major exception is that defined benefit plan participants generally have the ability to make an election as to the form of benefits. However, even that decision is fairly circumscribed. Since most defined benefit plans do not offer a lump sum option, participants essentially choose between a single life annuity and a joint annuity. BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, BULLETIN NO. 2517 EMPLOYEE BENEFITS IN MEDIUM AND LARGE PRIVATE ESTABLISHMENTS 103 (Sept. 1999) (23% of defined benefit plans offer availability of lump sum benefits at retirement). This decision is limited, however, since married participants must take their benefit in the form of a joint and survivor annuity, unless their spouse consents to a different form of benefit. See 29 U.S.C. § 1055(a), (b)(1), (c) (1994).

⁵² See generally *supra* note 2; Zanglein, *supra* note 3, at 227 (noting the number of defined benefit plans in the U.S. decreased by 60% between 1986 and 1995, while defined contribution plans increased by more than 400%). 401(k) plans did not exist at the time ERISA was enacted. It was not until 1978 that amendments to the Code made such plans feasible. See Revenue Act of 1978, Pub. L. No. 95-600, § 135, 92 Stat. 2763 (1978) (codified as amended at 29 U.S.C. § 401(k) (1994)).

As I have discussed elsewhere, there are varying opinions regarding the cause of the shift from defined benefit plans to defined contribution plans. See Stabile, *supra* note 14, at 75-77. Regardless of the reason for the shift, any discussion of pension reform must address a defined contribution plan universe. See Susan J. Stabile, *Paternalism Isn't Always a Dirty Word: Can*

In a 401(k) plan universe, there is less reason to be concerned with employer abuse and opportunism. First, benefits are largely provided by employee funds (except for matching contributions).⁵³ Second, such plans shift both the burden of investment decisions and the risk of portfolio loss from employers to employees.⁵⁴ For these reasons, the employer sponsoring a defined contribution plan does not stand as a player with interests opposed to employees in the same way it does in a defined benefit plan. There is less motivation and opportunity for employer abuse.⁵⁵ Once the employer has established a defined contribution plan, it is essentially agnostic regarding most employee choices.

the Law Better Protect Defined Contribution Plan Participants?, 5 EMPLOYEE RTS. & EMP. POL'Y J. 491, 510-13 (2001) (discussing why "defined contribution plans are here to stay").

⁵³ See Zanglein, *supra* note 3, at 228-29 (noting the primary cost to employers in 401(k) plans is the employer's contribution and other incidental and administrative costs are not significant). As to the employer contribution cost, there is evidence suggesting employers are cutting back their matching contributions to 401(k) plans. See, e.g., Josh Friedman, *First the Market Slump, Now Some Savers Losing 401(k) Match Funds*, L.A. TIMES, Nov. 11, 2001, at C1 (naming Wyndham Int'l and Bethlehem Steel as examples of companies recently suspending 401(k) plan contributions); Ellen E. Schultz, *Employers are Cutting 401(k) Plan Contributions*, WALL ST. J., June 20, 2001, at C1 (citing evidence from SEC filings showing companies across a range of industries contributing less to 401(k) plans in 2000 than in 1999); Jerry Cobb, *Companies Start to Trim 401(k) Contributions*, MSNBC, at <http://www.msnbc.com/news/634917.asp> (Sept. 27, 2001) (naming General Motors, Daimler Chrysler and Delphi Automotives, among others, as examples of companies who have cut 401(k) plan matching contributions).

⁵⁴ In contrast to a defined benefit plan, which promises a particular benefit level at retirement, participants in a defined contribution plan receive upon retirement whatever the value of their account happens to be. No specific benefit level is promised and the actual benefit depends on the amounts contributed and the investment returns on the contributions. See 29 U.S.C. § 1002(34) (1994).

⁵⁵ A notable exception is the actual contribution by the employer of employee salary deductions to plans. There have been numerous reported instances of delays or failures to contribute, notwithstanding a Department of Labor interpretation limiting the length of time between when a salary deduction is made and when the deducted amounts must be contributed into the plan. See 29 C.F.R. § 2510.3-102 (2001) (providing that employee deferral contributions become plan assets as of the earlier of the earliest date money can be segregated from the employer's general assets and the 15th day of the month after the money was withheld from the employee's wages and clarifying in subsection (f) that the 15th day of the next month is the latest possible date on which 401(k) deferrals must be contributed to the plan). In fact, the failure of employers to forward employee contributions to 401(k) plans is one of the top issues currently litigated by the Department of Labor. *ESOP Valuations, Contributions Among Top Issues Litigated by DOL*, PENS. & BEN. REP. (BNA) (Aug. 7, 2001).

Another exception relates to the issue of 401(k) plan fees and expenses, particularly the question of the appropriate allocation of fees between the employer and the plan (and therefore participants). See Virginia Munger Kahn, *When Hidden Fees Erode 401(k)'s*, N.Y. TIMES, Jul. 22, 2001, at C8 (discussing negative effect of administrative fees on 401(k) plan account balances). This subject has been of interest to the DOL for the last several years. See 2001 Op. Dep't of Labor 01A (2001) (providing guidance to employers regarding appropriate allocation of expenses between plan and employer). Several years ago, the DOL sponsored a study to examine the incidence, structure and magnitude of fees charged to plan sponsors and to participants. See PENSION AND WELFARE BENEFITS ADMINISTRATION, *STUDY OF 401(K) PLAN FEES AND EXPENSES* (1998) (copy on file with author).

Thus, the major concerns arising with defined contribution plans are different than those in a traditional defined benefit plan. By definition, the primary risks involve employee decisions. This raises the question whether the regulatory framework created by section 404(c) and the DOL's regulations still makes sense for a statute concerned with ensuring income security in retirement.

II. THE STATUTORY AND REGULATORY REQUIREMENTS

Section 404(c) of ERISA merely identifies the consequences flowing from a participant's exercise of control over the assets of her plan account, i.e., that the participant is not a fiduciary and no other fiduciary is liable for any losses caused by the participant's exercise of control. Congress anticipated difficulty in determining whether a participant exercised control over her account.⁵⁶ Congress therefore left to the DOL the task of giving content to the statutory requirement. Although it took some time to act, the DOL issued final regulations under section 404(c) in 1992.⁵⁷ Under the regulatory framework, in order to obtain the statutory result that a participant is not a fiduciary (and the employer not a co-fiduciary), the plan in question must be an "ERISA §404(c) plan" and the participant must exercise independent control over the assets in her account.⁵⁸

To qualify as an "ERISA §404(c) plan," the plan must be an individual account plan (1) providing participants an opportunity to exercise control over the assets in their individual accounts, and (2) providing participants the opportunity to choose among a broad range of investment options.⁵⁹ The opportunity to exercise control includes both a reasonable opportunity to give investment instructions to a fiduciary obligated to comply with the instructions,⁶⁰ and the opportunity to obtain sufficient information to make informed decisions among the various in-

⁵⁶ See H. Rep. No. 1280, at 305 (1974), reprinted in 1974 U.S.C.C.A.N. 5038, 5086; S. Rep. No. 93-1090, at 263.

⁵⁷ See Final Regulation Regarding Participant Directed Individual Account Plans, 57 Fed. Reg. 46,906 (Oct. 13, 1992) (codified at 29 C.F.R. §2550.404c-1). The final regulations were preceded by two sets of proposed regulations, the first of which were issued in 1987 and subjected to substantial criticism. See 52 Fed. Reg. 33508 (proposed Sept. 3, 1987). As a result, the DOL issued a new set of proposed regulations in 1991. See 56 Fed. Reg. 10724 (proposed Mar. 13, 1991). The 1992 final regulations became effective with respect to transactions occurring on or after the first plan day of the second plan year beginning on or after October 13, 1992. 29 C.F.R. § 2550.404c-1(g) (2001).

There is "a paucity of case law" interpreting section 404(c), making the regulations the only real source of guidance here. *Conner v. Mid S. Ins. Agency*, 943 F. Supp. 647, 659 n.12 (W.D. La. 1995).

⁵⁸ 29 C.F.R. § 2550.404c-1(a) (2001).

⁵⁹ 29 C.F.R. § 2550.404c-1(b)(1)(i)-(ii) (2001).

⁶⁰ 29 C.F.R. § 2550.404c-1(b)(2)(i)(A) (2001). The regulations clarify that a plan may impose reasonable restrictions on the frequency of investment instructions and it may impose a

vestment options offered under the plan.⁶¹ The opportunity to choose among a broad range of investment options translates into the participant having the opportunity to diversify her investments among at least three investment choices containing materially different risk and return characteristics.⁶² The opportunity to obtain sufficient information to make informed decisions among investment options was interpreted by the Third Circuit in *In re Unisys Savings Plan Litigation*⁶³ to require that the participant be provided with

information sufficient for the average participant to understand and assess: the control the Plans permitted a participant to exercise and the financial consequences he or she assumed by exercising that control; the rights that ERISA provided to participants and the obligations that the Act imposed on fiduciaries; the Plans' terms and operating procedures; the alternative funds the Plans offered; the investments in which assets in each fund were placed; the financial condition and performance of the investments; and developments which materially affected the financial status of the investments.⁶⁴

The second part of the regulatory framework requires a participant in fact exercise independent control over her account balance.⁶⁵ Whether a participant has actually exercised independent control with respect to her investment when she conveys investment instructions depends on the facts and circumstances of each particular case. The regulations specify that a participant's exercise of control is not independent if the participant was subject to improper influence by the employer or another plan fiduciary, if a plan fiduciary concealed material non-public information from the participant, or if the participant was not legally competent.⁶⁶

charge to cover the reasonable expenses of carrying out investment instructions. 29 C.F.R. § 2550.404c-1(b)(2)(ii)(A), (C) (2001).

⁶¹ The regulations require certain information be provided to all participants whether or not requested and that certain other information be provided upon request. 29 C.F.R. § 2550.404c-1(b)(2)(i)(B)(1)-(2) (2001). The former category includes descriptions of investment alternatives, information relating to investment instructions, and limitations and descriptions of transaction fees and expenses. The latter category includes copies of financial statements and information regarding underlying assets of the portfolio of each investment alternative. The information provided must be based on the latest information available to the plan. *See id.*

⁶² 29 C.F.R. § 2550.404c-1(b)(3) (2001). The regulations note that where participants' accounts are limited in size, the only prudent means to assure appropriate diversification is for a plan to offer look-through investment vehicles. *Id.*

⁶³ 74 F.3d 420 (3d Cir. 1996).

⁶⁴ *Id.* at 447.

⁶⁵ 29 C.F.R. § 2550.404c-1(c)(1) (2001).

⁶⁶ 29 C.F.R. § 2550.404c-1(c)(2) (2001).

A few observations about the regulatory framework are in order. First, the regulations do not require an employer to provide any kind of investment education or advice to employees.⁶⁷ Nonetheless, employers have recognized the desirability of providing some type of education to employees who direct the investment of their own account balances.⁶⁸ In order to allay employers' fears that providing such education would be considered "investment advice," thus rendering the employer a fiduciary,⁶⁹ the DOL issued an interpretive bulletin in 1996 relating to participant investment education.⁷⁰ The bulletin describes various categories of information and materials that may be provided to participants, without the risk of being considered investment advice within the meaning of ERISA and the DOL's regulations.⁷¹ These include plan information, information about general financial and investment concepts, asset allocation models providing strategies for obtaining hypothetical investment objectives, and interactive investment materials.⁷² Thus, the bulletin allows for the provision of generalized investment education, but not for individualized investment advice.

Second, the actual exercise of control requires participants to make an affirmative election regarding their plan account. The original regulations proposed by the DOL extended section 404(c) relief to situations where there was an absence of affirmative participant direction and contributions were invested in a "safe fund" as a default.⁷³ However, the final regulations provide no relief from ERISA's fiduciary responsibility provisions unless "decisions have affirmatively been made by participants and beneficiaries who have exercised independent control . . . Un-

⁶⁷ The regulations are silent on the question of education, but they specifically state that a fiduciary is under no obligation to provide any investment advice to a participant. 29 C.F.R. § 2550.404c-1(c)(4) (2001). See also 29 C.F.R. § 2509.96-1 n.1 (2001) (participant not required to be offered or provided with investment advice or education).

⁶⁸ See Jacqueline M. Quinn, *Mainstreaming Financial Education As an Employee Benefit*, J. FIN. PLAN., May 2000, at 70, 71; Gary Blau & Jack L. VanDerhei, *Employer Involvement in Defined Contribution Investment Education*, BENEFITS Q., Fourth Quarter 2000, at 80, 84-85.

⁶⁹ The statutory definition of fiduciary includes anyone who "renders investment advice for a fee or other compensation" with respect to any plan money or property. 29 U.S.C. § 1002(21)(A)(ii) (1994). DOL regulations elaborate in detail what it means to provide investment advice. 29 C.F.R. § 2510.3-21(c) (2001).

⁷⁰ DOL Interpretive Bulletin 96-1, 29 C.F.R. § 2509.96-1 (1996). The DOL noted in the bulletin that many employers have not offered programs or have only offered limited programs due to uncertainty regarding the extent to which the provision of investment-related information may be considered the rendering of investment advice under Section 3(21)(A)(ii) of ERISA, resulting in fiduciary responsibility and potential liability in connection with participant-directed investments. *Id.*

⁷¹ *Id.*

⁷² 29 C.F.R. § 2509.96-1(d)(4) (2001).

⁷³ See Proposed Regulations Regarding Participant Directed Individual Account Plans, 52 Fed. Reg. 33508 (Sept. 3, 1987) (codified at § 2550.404c-1(c)(4)).

less an affirmative instruction is given, there can be no relief under ERISA section 404(c).⁷⁴ Thus, in automatic enrollment plans, there is no section 404(c) relief unless a participant makes an affirmative election to change from the default contribution and investment options selected by the employer.⁷⁵

The decision to require an affirmative election as a precondition to satisfaction of section 404(c) makes sense. As Professor Brigitte Madrian and others have demonstrated, defaults are sticky and participants generally maintain the original contribution levels and investment options selected by the employer in automatic enrollment plans.⁷⁶ While such behavior may be the result of a careful determination that the choice selected by the employer is the best one, it more likely reflects no thought or decision at all. Thus, consistent with the transactional nature of the protection, i.e., the notion of section 404(c) protection extending only when a participant has actually exercised control, no protection should be granted unless and until a participant makes an affirmative election to change from the default option.

Although the decision to require an initial affirmative election by participants is clearly correct, query whether an initial election should be viewed as enough. A significant number of participants make initial participation and investment elections and then never monitor or reallocate their plan portfolio.⁷⁷ One should consider whether making a one-time decision to choose a specific portfolio and then doing nothing more, should be viewed as sufficient to constitute an exercise of control. Current law clearly views it in this manner.

⁷⁴ Federal Register, *supra* note 24, at 46,923.

⁷⁵ In automatic enrollment plans, employer distributes enrollment forms with a notice warning employees if they do not return the form, employees will be automatically enrolled at contribution rate specified in notice and in investment choice specified, which elections will remain in place unless the employee makes an alternative choice. This process was approved in 1998 by the IRS. See Rev. Rul. 98-30, 1998-25 I.R.B. 8; Rev. Rul. 2000-8, 2007-7 I.R.B. 617.

⁷⁶ Regarding the failure of participants to change default investment allocations made by the employer, see *Automatic Enrollment Boosts Plan Participation, But Workers Remain at Low Default Rates*, EMPLOYEE BENEFITS PLAN RPT. 25 (2000) (more than half of participants remain at default investment option). Regarding the stickiness of default rules generally, see BRIGITTE C. MADRIAN & DENNIS F. SHEA, THE POWER OF SUGGESTION: INERTIA IN 401(K) PARTICIPATION AND SAVINGS BEHAVIOR 14 (2000), available at <http://papers.ssrn.com/sol3/delivery.cfm/ooefm/00042403.pdf?abstractid=223635> (finding the vast majority of participants subject to open enrollment do not change the default investment options); see, e.g., Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. Rev. 630, 673-76 (1999) (discussing status quo bias and its effect on default rules); Cass Sunstein, *Switching the Default Rule*, 77 N.Y.U. L. Rev. 100, 111-19 (2002) (noting that labor and employment law default rules are likely to prove sticky because of their effects on employee judgments and valuations).

⁷⁷ See *infra* note 166.

Third, despite the fact that section 404(c) does not relieve a fiduciary plan sponsor from the obligation to prudently select investment vehicles and “to periodically evaluate the performance of such vehicles to determine, based on that evaluation, whether the vehicles should continue to be available as participant investment options,”⁷⁸ the section effectively prevents participants from forcing plan fiduciaries to satisfy these obligations. In *In re Unisys Savings Plan Litigation*,⁷⁹ plaintiffs alleged various breaches of fiduciary duty, including a breach of the duty of prudence in the inclusion of Executive Life Guaranteed Investment Contracts as one of the plan’s investment options⁸⁰ and a breach of the duty of diversification.⁸¹ Defendant Unisys asserted compliance with section 404(c) operated as a complete defense even if it failed to satisfy its duties of prudence and diversification since the plaintiffs’ exercise of control caused their losses rather than a breach of any fiduciary duties.⁸²

The Third Circuit accepted the argument section 404(c) “allows a fiduciary, who is shown to have committed a breach of duty in making an investment decision, to argue that despite the breach, it may not be held liable because the alleged loss resulted from a participant’s exercise of control.”⁸³ The court felt the plain language of the statute compelled this conclusion.⁸⁴ Under the court’s reasoning, if there is a causal nexus between the participant’s exercise of control and the claimed loss, then the fiduciary is effectively excused from its breach, even though the fiduciary’s breach presumably allowed the participant to exercise the control that caused the loss. Thus, the potential effect of section 404(c) is to immunize employers from liability for breaches of their fiduciary duties, substantially diminishing the protection afforded to participants by the duties imposed on fiduciaries under section 404(a) of ERISA.⁸⁵

⁷⁸ Federal Register, *supra* note 24, at 46,924 n.27 (Oct. 13, 1992) (Preamble to Final Regulations Regarding Participant Directed Individual Account Plans). See *Franklin v. First Union Corp.*, 84 F. Supp. 2d 720, 732 (E.D. Va. 2000) (noting plan fiduciary have prudence obligation with respect to selection and monitoring of plan investment alternatives).

⁷⁹ 74 F.3d 420 (3d Cir. 1996).

⁸⁰ *Id.* at 434.

⁸¹ *Id.* at 438.

⁸² *Id.* at 444-45.

⁸³ *Id.* at 445.

⁸⁴ *Id.*

⁸⁵ See Regina Jefferson, *Rethinking the Risk of Defined Contribution Plans*, 4 FLA. TAX REV. 607, 634 (2000) (noting in § 404(c) plans, participants are “barred from claiming that the employer either should have recognized a problem, or provided different investment options”).

I do not mean to suggest that § 404(c) completely deprives participants of any recourse with respect to an employer’s behavior with respect to its 401(k) plan. For example, a lawsuit alleging improper employer behavior with respect to use of a 401(k) plan to boost company profits resulted in favorable settlement in favor of plan participants. See *Franklin v. First Union Corp.*, 84 F. Supp. 2d 720 (1999). A \$26 million settlement was approved in June, 2001. *Id.*; Alan Cooper, *First Union Settlement Gets Nod*, RICHMOND TIMES-DISPATCH, June 14, 2001, at B8.

The Third Circuit's decision in *Unisys* addressed only the statute, since the transactions subject to the complaint predated the effective date of the DOL's section 404(c) regulations.⁸⁶ The final regulations, however, do no violence to the court's reasoning. Indeed, the court's reasoning there can be no liability because any loss resulted from the participant's exercise of control is quite consistent with language in the preamble to the final 404(c) regulations. The regulations relieve plan fiduciaries from liability for losses "which 'result' from a participant's or beneficiary's exercise of control," and state that in any given situation it is "necessary to determine whether alleged losses or violations resulted from participant's or beneficiary's investment decision."⁸⁷

III. THE ILLUSION OF PARTICIPANT CONTROL

ERISA section 404(c) embodies Congress' judgment that employers should bear no responsibility for investment losses in situations where a participant has exercised control over her 401(k) plan account. The reason for vitiating employer liability is that any loss has been caused by the participant's exercise of control and not by any act of the employer. This section questions this conclusion, suggesting that even plans satisfying the statutory and regulatory definition of control offer only an illusion of control. This is true for two reasons: first, the framing effect allows employers and other fiduciaries to retain significant influence over participant decisions; second, the ultimate beneficiaries exercise no control over plan decisions.

A. CONTEXT DEPENDENCE

Classical choice theory assumes each alternative considered by a decision-maker has a particular utility value and the decision-maker will select the alternative with the highest value to her.⁸⁸ If choice theory accurately describes how individuals make decisions, then a participant choosing from a set of investment alternatives based on adequate disclosure would arguably exercise meaningful control over her plan account by virtue of making that decision.

However, an important insight of behavioral theorists is the notion of context-dependence. This idea holds both the options presented to a decision-maker and how those options are presented affects the choices

⁸⁶ See *Unisys*, 74 F.3d at 444 n.21.

⁸⁷ Federal Register, *supra* note 24, at 46,924 (Oct. 13, 1992).

⁸⁸ See Itamar Simonson & Amos Tversky, *Choice in Context: Tradeoff Contrast and Extremism Aversion*, 29 J. MARKETING RES. 281, 281 (1992) (describing choice theory).

to be made.⁸⁹ This is more than a theoretical idea.⁹⁰ Numerous studies have empirically verified the extent to which “people’s preferences are affected by the set of options under consideration.”⁹¹ Offering people additional choices influences people to choose an option they would have declined if fewer options were available.⁹² Professor Sunstein gives a simple example of this effect: whereas most people choosing between a small radio and a mid-sized radio may choose the small radio, given a choice among a small, a mid-sized and a large radio, many of those same people will choose the mid-sized radio.⁹³ The opportunity for an additional choice increases the likelihood a decision-maker will choose an option similar to the added choice.⁹⁴

In addition, how choices are presented has a significant impact on how a decision-maker will choose among them.⁹⁵ This result may arise because different means of presenting the options “highlight different aspects of options and suggest alternative heuristics, which may give rise to inconsistent responses.”⁹⁶ For example, two choices may offer the same change from the status quo. Yet, whether they are phrased in terms of gains or losses has a significant effect because of the operation of loss aversion where individuals attach “more disutility to losses than utility to gains.”⁹⁷

⁸⁹ See Mark Kelman et al., *Context-Dependence in Legal Decision Making*, 25 J. LEG. STUD. 287 (1996).

⁹⁰ Various theories explain context-dependence. One is tradeoff contrast, the tendency to view an option as favorable or not depending on how it compares to other options under consideration. Another is extremeness aversion, in which the attractiveness of an option is diminished if it is an extreme option. *Id.* (finding the existence of both tradeoff contrast and extremeness aversion); Simonson & Tversky, *supra* note 88 (discussing findings supporting both tradeoff contrast and extremeness aversion). See also Joel Huber & Christopher Puto, *Market Boundaries and Product Choice: Illustrating Attraction and Substitution Effects*, 10 J. CONSUMER RES. 31 (1983) (discussing evidence of both substitution effect and attraction effect).

⁹¹ Amos Tversky & Itamar Simonson, *Context-Dependent Preferences*, 39 MGMT. SCI. 1179, 1187 (1993).

⁹² See Donald A. Redelmeier & Eldar Shafir, *Medical Decisionmaking in Situations That Offer Multiple Alternatives*, 273 JAMA 302 (1995). This finding casts doubt on a classical choice theory of value maximization, which implies context independence. Under a value maximization theory, the relative ranking of any two options should not be affected by the presence of additional options. “A person who prefers chicken over pasta should not change this preference on learning that fish is also available.” Kelman, *supra* note 89, at 287.

⁹³ CASS R. SUNSTEIN, *BEHAVIORAL LAW & ECONOMICS* 3 (2000).

⁹⁴ Joel Huber et al., *Adding Asymmetrically Dominated Alternatives: Violations of Regularity and the Similarity Hypothesis*, 9 J. CONSUMER RES. 90 (1982); Douglas H. Wedell, *Distinguishing Among Models of Contextually Induced Preference Reversals*, 17 J. EXPERIMENTAL PSYCHOL. 767 (1991).

⁹⁵ Eldar Shafir et al., *Reason-Based Choice*, 49 COGNITION 11, 15–18 (1993).

⁹⁶ Amos Tversky et al., *Contingent Weighting in Judgment and Choice*, 95 PSYCHOL. REV. 371 (1988).

⁹⁷ Edward J. McCaffery et al., *Framing the Jury: Cognitive Perspective on Pain and Suffering Awards*, in *BEHAVIORAL LAW AND ECONOMICS* 259, 262 (Cass R. Sunstein ed.,

There is also empirical support for the effects of context dependence in participant investment decisions. For example, regarding the question of the effect of options presented, the Employee Benefits Research Institute's ("EBRI") findings with respect to its comparison of plans offering guaranteed investment contracts ("GIC") and employer stock funds with plans offering only one or the other or neither choice are instructive. The EBRI study found plans offering neither option have the highest allocations to equity funds, whereas the presence of either a GIC fund or an employer stock fund, but not the other, resulted in substantially lower allocations to all other funds.⁹⁸ Further work by Professors Shlomo Benartzi and Richard Thaler find evidence of extremism aversion in plan investor choices. Specifically, whether a particular portfolio option is framed as the middle choice or an extreme choice affects the preference for the option.⁹⁹

The EBRI study also found requiring company matching contribution to be invested in employer securities causes participants to direct a higher percentage of their self-directed funds there as well.¹⁰⁰ Professor Benartzi refers to this phenomenon as an "endorsement effect," by which he suggests a participant interprets matches in employer securities "as an endorsement or as implicit investment advice."¹⁰¹ Professor Benartzi found similar endorsement effects in two other studies. In one, participant contributions were matched by employer contributions to an international equity fund, resulting in a significant percentage of participants indicating a willingness to put more of their own contributions into an international equity fund.¹⁰² In the second, more than half of respondents indicated they would put more of their own funds into equities if they were to receive a match into a diversified equity fund.¹⁰³ These findings illustrate plan design possessing a significant effect on participant decisions, which may be because participants "do not really have

2000). See Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1102-03 (2000) (discussing effect of framing economically equivalent options in different terms). As Professors Korobkin and Ulen note, this aspect of the framing effect is inconsistent with rational choice theory because it violates "the invariance principle, which posits that the manner in which a choice is presented should not affect the selection an actor makes so long as the variation in presentation does not affect the outcomes of the choices." *Id.* at 1103.

⁹⁸ Stabile, *supra* note 14, at 87 (discussing the EBRI findings).

⁹⁹ Shlomo Benartzi & Richard H. Thaler, *How Much is Investor Autonomy Worth?*, at 18-20 (Mar. 2001), available at <http://gsbwww.uchicago.edu/fac/richard.thaler/research/Autonomy.pdf>.

¹⁰⁰ Stabile, *supra* note 14, at 87.

¹⁰¹ Shlomo Benartzi, *Excessive Extrapolation and the Allocation of 401(k) Accounts to Company Stock*, 56 J. FIN. 1747, 1752 (2001).

¹⁰² *Id.* at 1754 (reporting 45% of respondents would put more of their contributions into international equity funds).

¹⁰³ *Id.* (reporting 51% of respondents would put more of their contributions into equity).

well-formed preferences, but rather construct preferences when choices are elicited” based on the choices presented.¹⁰⁴

Empirical evidence supports the effect on participants in 401(k) plans of how information is presented. Professors Benartzi and Thaler’s study of participant behavior found the presentation of rates of return affected participants’ decisions regarding how much to invest in equities.¹⁰⁵ Specifically, they found that participants who are presented with long-term returns invest more in equities than those presented with one-year returns, which Benartzi and Thaler attribute to myopic loss aversion.¹⁰⁶

Thus, there is convincing evidence that “individual decision-makers [are] susceptible to manipulation by those able to influence the context in which decisions are made.”¹⁰⁷ This context-dependence is not necessarily troubling in all contexts. For example, in many consumer situations, where ends are less clearly defined, we may not care when choices are being manipulated.¹⁰⁸ To use Professor Sunstein’s example,¹⁰⁹ we may not care that consumers who would otherwise choose to purchase a small radio are manipulated into purchasing a medium-sized radio by the introduction of the additional choice of a large radio. Here, there is a clearly defined end: adequate retirement income. More importantly, in terms of the current discussion, context-dependence means that, notwithstanding participant-direction, participants are not truly exercising sole independent control over their accounts. By controlling which investment options are offered in a plan, how many options are offered, how the options are presented, and what types of disclosures about the choices are made, employers retain significant control over employee choices. At a minimum, in any given situation, there is at least a factual question about whether an employer’s action significantly influenced employee choice.

Given the theoretical underpinnings of section 404(c), this is a troublesome issue without regard to whether employers intentionally frame choices with the aim of influencing participant choice. Even in the absence of affirmative attempts to manipulate participant choice, employer choices inadvertently influence participant decisions, undermining the basis for section 404(c).

¹⁰⁴ Benartzi & Thaler, *supra* note 99, at 17.

¹⁰⁵ Shlomo Benartzi & Richard H. Thaler, *Risk Aversion or Myopia? Choices in Repeated Gambles and Retirement Investments*, 45 *MGMT. SCI.* 364 (1999); Jon D. Hanson & Douglas A. Kysar, *supra* note 76, at 685 (discussing findings of Benartzi and Thaler).

¹⁰⁶ Benartzi & Thaler, *supra* note 105, at 375, 377.

¹⁰⁷ Hanson & Kysar, *supra* note 76, at 635.

¹⁰⁸ Kelman, *supra* note 89, at 303–04 (contrasting concern over context-dependence in legal vs. consumer decision-making, suggesting the latter is less of a problem because consumer lacks clearly defined ends).

¹⁰⁹ See *supra* text accompanying note 93.

There is even more reason for concern if, in fact, employers or other fiduciaries are intentionally using their ability to frame choices to affect participant decisions.¹¹⁰ Motives to manipulate certainly exist. On the employer side, an employer's desire to put company shares in friendly hands may lead to attempts at influencing participants to invest more of their funds in employer securities,¹¹¹ a concern expressed in the legislative history of section 404(c).¹¹² Regulations require section 404(c) plans to contain procedures designed to safeguard the confidentiality of information relating to the acquisition and disposition of employer securities¹¹³ and to appoint an independent fiduciary to carry out activities relating to any situations determined by the designated plan fiduciary to have the potential for undue employer influence.¹¹⁴ However, the fact that 401(k) plans are so heavily invested in employer securities¹¹⁵ suggests such manipulation may be occurring.¹¹⁶ Indeed, a recent lawsuit

¹¹⁰ Scholars examining framing in other contexts have raised a concern with purposeful manipulation. *See, e.g.*, Hanson & Kysar, *supra* note 76 (discussing possibility of market manipulation in the products liability area).

¹¹¹ It is difficult to find any other source for an employer's desire to manipulate choices. Apart from a desire to encourage participants to hold more employer securities, the employer is likely to be agnostic regarding participant investment choices.

¹¹² The conferees expect that the regulations will provide more stringent standards with respect to determining whether there is an independent exercise of control where the investments may inure to the direct or indirect benefit of the plan sponsor since, in this case participants might be subject to pressure with respect to investment decisions. (Because of the difficulty of ensuring that there is independence of choice in an employer established individual retirement account, it is expected that the regulations will generally provide that sufficient independent control will not exist with respect to the acquisition of employer securities by participants and beneficiaries under this type of plan.)

H.R. CONF. REP. NO. 1280, 305 (1974).

¹¹³ 29 C.F.R. § 2550.404c-1(d)(2)(ii)(E)(4)(vii)-(viii) (2001). What procedures are necessary and sufficient to protect confidentiality is not an issue explored in the regulations. *Id.*

¹¹⁴ 29 C.F.R. § 2550.404c-1(d)(2)(ii)(E)(4)(ix). What is contemplated here is the appointment of an independent fiduciary to handle situations such as tender offers and contested board elections. *See id.* The regulations specifically provide voting and tender decisions with respect to employer securities must be passed through to plan participants holding such securities in their plan accounts. *Id.* at (d)(2)(ii)(E)(4)(vi).

¹¹⁵ *See* Sarah Holden & Jack VanDerhei, *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2000*, 7 INVESTMENT COMPANY INSTITUTE PERSPECTIVE, at 9, Figure 8 (Nov. 2001) (finding employees participating in 401(k) plans offering an employer stock fund invest an average of 1/3 of their account balance in company stock); Theo Francis, *Company Stock Fills Many Retirement Plans Despite the Potential Risks to Employees*, WALL ST. J., Sept. 11, 2001, at C1 (reporting findings of Institute of Management and Administration that the 401(k) plans of one in five companies are more than 50% invested in company stock); Patrick J. Purcell, *The Enron Bankruptcy and Employer Stock in Retirement Plans*, CRS Report for Congress, Jan. 22, 2002, at 4, Table 1 (giving examples of major companies whose 401(k) plans are more than 85% invested in company stock).

¹¹⁶ A recent lawsuit filed against Lucent Technologies alleges such manipulation. *Reinhart & Smith v. Lucent Tech., Inc.*, Civ. 01-CV-3491 (D.N.J. 2001). The complaint alleges Lucent inducing plan participants to invest, or continue to invest in, Lucent stock despite the company knowing of serious business problems that would adversely affect the value of the stock. *Id.* A similar such action is in progress against Ikon Office Solutions, in which class

filed by disgruntled employees of Enron Corporation suggests exactly that.¹¹⁷ Employees whose 401(k) plan accounts were heavily invested in Enron shares argue that they were prevented from switching out of that investment option and into less risky choices during a time when Enron shares were tumbling in value. As a result, some employees lost hundreds of thousands of dollars.¹¹⁸

In addition, employers may not be the only persons who may have an interest in influencing employee choice framing. As discussed earlier, a DOL interpretive bulletin allows for participants to receive asset allocation models and interactive investment materials. Professor Colleen Medill argues serious potential for service providers exists to use such models and materials to “steer” plan participants into certain funds offered as investment options in a 401(k) plan.¹¹⁹ Specifically, service providers have a financial incentive to steer participants into funds paying the largest fees to the service provider.¹²⁰

Greater reasons to fear the effect of framing by actions of service providers may arise in the future. Congress is currently considering legislation aimed at providing more meaningful investment education and advice to 401(k) plan participants.¹²¹ The Pension Security Act of 2002¹²² would allow the same companies who administer 401(k) plans

certification has been granted. *In re Ikon Office Solutions, Inc.*, 191 F.R.D. 457 (E.D. Pa. 2000).

¹¹⁷ Richard A. Oppel, Jr., *Employees' Retirement Plan is a Victim as Enron Tumbles*, N.Y. TIMES, Nov. 22, 2001, at A1. At the time the plan was amended to freeze asset allocation, Enron shares were trading at \$32.20. On November 21, Enron closed at \$5.01. *Id.*

¹¹⁸ *Id.* Enron's explanation for the freeze on trading was that it was switching plan administrators and the shutdown was required to allow for an accurate transfer of employee account information. *Id.* Kristen Hays, *Enron Defends Routine Freezing of 401(k) Accounts*, HOUSTON CHRONICLE, Dec. 14, 2001, available at <http://www.chron.com/cs/CDA/print-story.htm/special/enron/1173285>. While the motivation for the freeze may have been benign, the timing certainly was not. *Id.*

¹¹⁹ Medill, *supra* note 45, at 55–56.

¹²⁰ *Id.* Professor Medill observes, this steering problem is particularly dangerous because employers and plan participants tend to be ignorant of the impact of mutual fund fees on a participant's account balance. *Id.* at 57.

¹²¹ The purpose of the proposed legislation is to address perceived inadequacies in Interpretive Bulletin 96-1, discussed *supra* at text accompanying notes 70-72. As DOL Assistant Secretary Ann Combs testified during hearings on the bill, the interpretive bulletin made clear that investment education could be provided to participants without giving rise to fiduciary responsibility. However, she noted “in view of what is at stake, many 401(k) plan participants, even with investment education tools available, desire personally tailored advice. Investment education, while important, is simply not enough.” See *The Retirement Security Advice Act: Hearing on H.R. 2269 Before the Comm. on Educ. and the Workforce*, 107th Cong. (2001) [hereinafter *Hearings*] (testimony of Hon. Ann L. Combs).

¹²² H.R. 3762, 107th Cong. (2001). The House passed the bill on April 11, 2002. Although the Pension Security Act of 2002 is broader than its predecessor, its provisions regarding investor advice were contained in an earlier bill that was passed by the House last year. See H.R. 2269, 107th Cong. (2001). The House passed the bill on November 15, 2001, and referred it to the Senate Committee on Finance.

and sell investment products to provide investment advice to plan participants, as long as they disclose any conflict of interest to participants.¹²³ Such companies obviously have an interest in influencing employee decisions and various groups have expressed concern about letting sellers of investment products also be the providers of investment advice.¹²⁴ As one Congressman observed commenting on an earlier version of this proposal, the proposed bill effectively puts pensions of American workers “in the hands of people who have a vested interest in directing them in a particular direction.”¹²⁵

The disclosure approach adopted by the proposed legislation is particularly unlikely to be helpful here.¹²⁶ Participants want and need investment advice¹²⁷ and the advice being offered by the conflicted service provider is the only advice available.¹²⁸ Moreover, disclosure notwithstanding, participants will likely view the service provider as carrying an employer imprimatur. Finally, participants may not sufficiently under-

¹²³ This allowance takes the form of an exemption to ERISA’s prohibited transaction rules allowing financial institutions providing investment alternatives and administrative and other services to participant-directed plans to also provide investment advisory services to plans and participants. See H.R. 3762 § 105. The Department of Labor has already granted individual exemptions from the prohibited transaction rules in particular situations to allow the provision of recommendations by investment companies who oversee 401(k) plan accounts. See, e.g., 2001 Op. Dep’t of Labor 09A (2001) (Advisory Opinion issued to Kirkpatrick & Lockhart on behalf of SunAmerica).

¹²⁴ See, e.g., Christiane Bird, *Retirement Security Advice Act Draws Mixed Reactions*, DOW JONES NEWS SERVICE, Jun. 25, 2001 (noting that many oppose allowing investment managers who serve as advisors to pension plans to recommend their own investment product and not requiring plan sponsor to monitor the advice provided).

The proposed legislation invites the same kind of conflict of interest that has given rise to recent securities lawsuits against investment analysts. Investment banks have dual relationships with issuers, with one arm handling deals for issuers and a research arm making “buy” recommendations for the same companies. The conflict of interest has given rise to suits against analysts as stock prices have fallen.

¹²⁵ 147 CONG. REC. H8189-02 (Nov. 15, 2001) (statement of Rep. McDermott).

¹²⁶ During hearings on an earlier version of the Retirement Security Act of 2002 bill, the Associate General Counsel of the AFL-CIO observed, “[i]n light of the manifest failures of this disclosure regime to adequately protect individual investors in the securities markets, it is richly ironic to suggest that Congress should not dismantle the substantive protections in the area of investment advice on which defined contribution plan participants now depend in favor of an alternative model that appears to be in crisis.” See *Hearings, supra* note 121 (testimony of Damon A. Silvers).

The House specifically rejected the argument requiring employers to offer an unaffiliated adviser on the grounds of the cost increases. See H.R. Rep. 107-262, at 14-15 (2001).

¹²⁷ *New Survey Shows Employees Want Employer-Provided 401(k) Investment Advice*, NEWS FROM THE COMMITTEE ON EDUCATION AND THE WORKFORCE, Sept. 4, 2001, available at <http://edworkforce.house.gov/press/press107/survey401k9401.htm> (citing survey finding that more than 75% of employees desire employer-provided investment advice).

¹²⁸ The introduction of the legislation itself evidences this. The legislation would not be necessary if employees had the financial ability to get advice on their own.

stand the disclosure provided.¹²⁹ For all of these reasons, the adviser's advice is likely to carry great weight. This concern is aggravated since the proposed legislation would only impose a general obligation on employers to monitor, not an obligation to monitor specific advice.¹³⁰

If purposeful manipulation occurs, then the provisions in the 404(c) regulations regarding independence will probably be insufficient to screen out such influence. In addition to the provisions regarding employer securities referred to above, the two regulatory conditions which will defeat a finding of an independent exercise of control that relate to an attempt to manipulate are: first, the participant subjected to improper influence by a plan fiduciary; and second, a plan fiduciary concealing material non-public facts regarding the investment. While the latter may be clear,¹³¹ the regulations do not elaborate on what it means for a participant to be subject to improper influence by a plan fiduciary.¹³² The influence we are talking about here is a very subtle one, one unlikely to be noticed by participants themselves,¹³³ let alone manipulation that could be proven if the issue arose in litigation.

One way to avoid problems created by framing is moving to so-called "open option" plans, as a number of employers have done.¹³⁴

¹²⁹ See *Advice from Whom?*, PENSION & INVESTMENTS, July 9, 2001, at 10 (raising concern about whether participants will understand disclosure about fees and conflicts of interest).

¹³⁰ The bill provides that a plan sponsor or other person who is a plan fiduciary "has no duty under this part to monitor the specific investment advice given by the fiduciary adviser to any particular recipient of such advice." See H.R. 2269, *supra* note 122, at 3.

To avoid the problem of conflict of interest, advice to participants should be provided by third parties who have no vested interest in the decision reached by participants. As a practical matter, this may not be easy to achieve since there may be insufficient economic incentive for third parties to enter the picture and neither employers nor employees want to devote substantial resources to obtain disinterested advice.

¹³¹ I mean clear in the sense of a well-developed body of securities law existing from which to extrapolate the definition of material non-public information relevant to the purchase or sale of a security.

¹³² This was a concern specifically raised by some of those who commented on the DOL's proposed regulations. In discussing the comments in the preamble to the final regulations, the DOL specifically stated that it was not prepared to give specific examples of what might constitute such improper influence saying only that "the question of whether there has been improper influence by a plan sponsor or fiduciary in a given situation is inherently factual in nature and can only be determined on a case by case basis, taking into account all surrounding facts and circumstances." 57 Fed. Reg. 46,906, 46,923 (Oct. 13, 1992) (to be codified at 29 C.F.R. pt. 2250).

¹³³ The unawareness of consumers of the impact and extent of market manipulation in the consumer context suggests that participants are not likely to notice manipulation of their preferences in the 401(k) context. Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: Some Evidence of Market Manipulation*, 112 HARV. L. REV. 1420, 1422 (1999).

¹³⁴ Morton A. Harris, *Working with Participant Directed Investment Options Under ERISA §404(c)*, SE02 ALI-ABA 893, 898, July 5, 1999 (noting that a growing number of plans are open option plans); see also HEWITT ASSOCIATES, *SURVEY FINDINGS: SELF-DIRECTED BROKERAGE ACCOUNTS AND FUND WINDOWS IN 401(K) PLANS* 1, 3 (2001) (noting large number of companies offering or thinking about offering self-directed brokerage options in plans).

Open option plans allow participants to invest their account balances in any publicly traded securities. While such plans may minimize the manipulation created by the framing effect in the sense that they provide virtually unlimited investment options, they magnify the problems of cognitive biases.¹³⁵ In addition, such plans, by freeing the employer from the need to determine the prudence of particular investment options, go a long way towards removing what little protection the law gives employees.¹³⁶

B. WHO EXERCISES CONTROL?

Subsection A argued that the individuals making decisions in 401(k) plans do not, in fact, exercise meaningful control because of the influence exerted by employers and other fiduciaries. This subsection argues that even if a current contributor to a 401(k) plan exercises control, the future beneficiary of a 401(k) plan account—for whose benefit ERISA was enacted—exercises no control over the account.

ERISA and the case law interpreting the statute recognize a difference between a plan participant in her capacity as current employee (current contributor) and a plan participant in her capacity as future retiree (future beneficiary). Where the two capacities conflict, the interests of the current contributor must be subordinated to the interests of the future beneficiary. For example, in *Donovan v. Bierwirth*,¹³⁷ employees, concerned about their present jobs (i.e., their status as employees) approved of an action by plan trustees in purchasing additional shares of employer securities in order to thwart an attempted takeover of the company. This did not prevent the court from finding a breach of a duty of loyalty to the participants qua participants (i.e., future beneficiaries).¹³⁸ Similarly, DOL regulations prohibit loans to participants at below-market interest rates,¹³⁹ despite the appeal of such loans to current contributors in their capacity as employees.

¹³⁵ See *infra* notes 156–172 and accompanying text.

¹³⁶ Harris, *supra* note 134, at 919 (noting open option plans are “an attractive approach to an employer who wants to reduce its fiduciary burden in connection with the selection and monitoring of the investment fund alternatives since an employer can avoid this process altogether”); see also HEWITT ASSOCIATES, *supra* note 134, at 27 (reporting survey findings that one reason plans offer brokerage accounts is to avoid monitoring funds). The section 404(c) regulations make clear that if a plan gives participants control over the selection of investment managers, the fiduciary has no liability for the performance of the investment manager. 29 C.F.R. § 2550.404c-1(f)(9).

¹³⁷ 680 F.2d 263, 270 (2d Cir. 1982).

¹³⁸ *Id.*

¹³⁹ 29 C.F.R. § 2550.408b-1(a)(1)(iv) (2001). These regulations effectively overturned an earlier court decision that had suggested below market loans were not a prohibited transaction so long as the loans bore a reasonable rate of interest. See *Brock v. Walton*, 794 F.2d 586 (11th Cir. 1986).

The law of trusts also recognizes this same distinction between the interests of the present self and the interests of the future. Trust law permits persons to create an irrevocable trust for the benefit of the person's own future security as well as his beneficiaries, which has the effect of placing limits on the grantor's (present self's) use of her assets.¹⁴⁰ It also allows the creation of a revocable trust for the purpose of managing the grantor's assets in the event of future incapacity.¹⁴¹ Both reflect recognition of a person's future interests being separable from her present interests.

The bioethics community has made a similar distinction between the interests of the present vs. the future self, regarding reliance on advance medical directives. In determining whether medical treatment may be withheld, a consensus has developed that treatment preferences expressed by incompetent persons at a prior time (when they were competent) should be given effect. One of the ways such preference is expressed is through advance treatment directives, in the form of living wills or other instructions regarding medical treatments and interventions.¹⁴² Not only does every state now have a statute providing for living wills or their equivalent,¹⁴³ but federal law requires federally funded hospitals to inform patients of their right to make advance medical directives and to honor those directives when made.¹⁴⁴

Many commentators have expressed concern about advance medical directives based on what might be termed competence concerns, i.e., concerns that persons executing living wills are unable to anticipate many of the possible health crises in the future and they lack information at the time that they give such directives regarding possible treatment options available in the future.¹⁴⁵ Professor Rebecca Dresser has ad-

¹⁴⁰ Once an interest is created on behalf of future beneficiaries, no revocation of the trust or change to its terms is permitted without the consent of all beneficiaries. See, e.g., N.Y. EST. POWERS & TRUSTS § 7-1.9(a) (McKinney 2001).

¹⁴¹ For a discussion of the use of revocable trusts to deal with future incapacity, see G. Warren Whitaker, *Using Revocable Trusts in New York: Why Not?*, N.Y. L.J., Sept. 22, 2000, at 1.

¹⁴² Thomas May, *Reassessing the Reliability of Advance Directives*, 6 CAMBRIDGE Q. HEALTHCARE ETHICS 325, 326 (1997) (explaining various forms of advance medical directives).

¹⁴³ Thaddeus Mason Pope, *The Maladaptation of Miranda to Advance Directives: A Critique of the Implementation of the Patient Self-Determination Act*, 9 HEALTH MATRIX 139, 149 n.48 (1999) (noting by 1992, all 50 states had advance directive legislation).

¹⁴⁴ Patient Self-Determination Act of 1990, 42 U.S.C. § 1395cc(f)(2)(A) (1994). See also *Cruzan v. Dir. Mo. Dep't of Health*, 497 U.S. 261 (1990) (recognizing a constitutionally guaranteed right to refuse treatment and holding that clear and convincing evidence of treatment preference before a patient becomes incompetent must be respected).

¹⁴⁵ See, e.g., Norman L. Cantor, *Conroy, Best Interests, and the Handling of Dying Patients*, 37 RUTGERS L. REV. 543, 559-60 (1985); Arnold S. Relman, *Michigan's Sensible "Living Will"*, 300 NEW ENG. J. MED. 1270, 1271 (1979). See also Pope, *supra* note 143, at 157-167, 167-68 n.139 (presenting empirical evidence suggesting most advance directives

vanced a much more interesting objection to advance medical directives, suggesting that “a person’s interests can change radically over time, so radically that in some cases it could be said that a different person exists by the time the life and death treatment situation arises.”¹⁴⁶ The notion is that an individual who becomes incompetent undergoes such radical differences in values and attitudes that she is not the same person as the person who executed the advance medical directive. Since, as Dresser observes, the basis for respecting advance medical directives is an assumption that the person expressing the advance preference is the same person whose treatment is later at issue,¹⁴⁷ if the past and present individuals are not the same person, there is no reason to give authority to the advance directive.¹⁴⁸

Professor Dresser buttresses her argument with British philosopher Derek Parfit’s “Complex View” of personal identity, “which holds that identity exists in varied degrees over time, depending on the strength of connectedness and continuity between an individual’s psychological features, such as memories, intentions, beliefs and desires.”¹⁴⁹ Parfit argues that rather than being a single self existing over the course of one’s entire life, a life is composed of several selves.¹⁵⁰ A self is a part of our lives to which we have the strongest psychological connection at any given time.¹⁵¹

completed pursuant to federal law are done so “under conditions not conducive to good decision-making”).

¹⁴⁶ Rebecca Dresser, *Life, Death, and Incompetent Patients: Conceptual Infirmities and Hidden Values in the Law*, 28 ARIZ. L. REV. 373, 379 (1986). See Sanford H. Kadish, *Letting Patients Die: Legal and Moral Reflections*, in IN HARMS WAY: ESSAYS IN HONOR OF JOEL FEINBERG 290, 300 (Jules L. Coleman & Allen Buchanan eds. 1994) (noting “the effect of severe, life-imperiling illness may well effect a marked revision in the attitudes and values of the person”); Pope, *supra* note 143, at 172–73 (empirically, the future incompetent individual is “radically psychologically different” from the person who executed the advance medical directive).

¹⁴⁷ Dresser, *supra* note 146, at 380.

¹⁴⁸ *Id.* (“The possibility that a person’s interests can change significantly and that a different person might emerge with the passage of time casts doubt on the authority of past preferences to govern treatment decisions for incompetent patients.”). See JOEL FEINBERG, HARM TO SELF: THE MORAL LIMITS OF THE CRIMINAL LAW 370 (1986) (suggesting that we can’t be “sufficiently confident that the earlier self, acting on the basis only of a partial anticipation of the eventual situation, would not himself have chosen to revoke had he been able to foresee precisely these circumstances in every relevant detail”); Pope, *supra* note 143, at 172 (accepting that if Dresser’s personal identity premise is valid, it is a convincing argument against advance directives and has validity). Sanford Kadish does not express the point as strongly as does Professor Dresser, but he does agree in viewing changed circumstances, disregarding advance directives does not pose a deep inroad into the autonomy principle. See Kadish, *supra* note 146, at 300.

¹⁴⁹ Dresser, *supra* note 146, at 380 (explaining Derek Parfit’s theory of personal identity).

¹⁵⁰ Derek Parfit, *Later Selves and Moral Principles*, in PHIL. & PERS. REL. 137, 140–41 (1973), cited in Dresser, *supra* note 146, at 380.

¹⁵¹ *Id.*

While the individual, who made the advance medical directive and the future person subject to its directives, is the same person from a legal standpoint,¹⁵² they are psychologically very different persons. Thus, according to Dresser, advance medical directives should not control when making decisions about what medical care to provide (or not provide) an incompetent patient.¹⁵³ In short, giving effect to such directives cannot promote autonomy.¹⁵⁴

The distinction made in the ERISA context, as a matter of trust law and in the advance medical directive area,¹⁵⁵ suggests a problem with the notion of control that underlies Congress' decision in section 404(c). The distinction means the future beneficiary, the retiree who will receive the plan benefits, exercises no control. The only control being exercised is by the current contributor, who may or may not, left to her own devices, exhibit sufficient concern for the future beneficiary. The law currently does not force her to do so, since the consequence of section 404(c) is to regard such decisions as not subject to any fiduciary standards.

Important consequences follow from this. First, it raises questions about the statutory decision to take employers off the hook for participant 401(k) plan decisions. Given what the distinction between the current contributor and the future beneficiary does to the basis for section 404(c), unless an employer creates conditions forcing current contributors to protect future beneficiaries, what is the basis for removing employer liability?

Second, it says something about allowing participants to make decisions subject to no standards. To make the argument in its broadest possible terms: if the future beneficiary is regarded as another person, even under the most conservative notions of what justifies government intervention, we can justify steps to prevent current contributors from causing harm to future beneficiaries. Participants' history of irrational plan choice, combined with the disastrous consequences certain to flow from

¹⁵² Pope, *supra* note 143, at 173 (noting that Dresser's theory does not fit the way Western law treats individual identity).

¹⁵³ Dresser, *supra* note 146, at 381.

¹⁵⁴ Some have criticized Dresser's position. See, e.g., Ben A. Rich, *Prospective Autonomy and Critical Interests: A Narrative Defense of the Moral Authority of Advance Directives*, 6 CAMBRIDGE Q. OF HEALTHCARE ETHICS 138 (1997) (rejecting Dresser's notion of personal identity and arguing in favor of a more Lockean understanding of personal identity).

¹⁵⁵ It is true the advance medical directive situation is somewhat different from the question of 401(k) plan decision-making. In the advance medical directive context, the issue is whether to give effect to an earlier decision at a later time; no contemporaneous choice of an individual is being disregarded. Here the question is whether there is a basis to, in effect, disregard a contemporaneous choice, to interfere with a choice currently being made by a plan participant. But the point is fundamentally the same – the desire to avoid saddling the future self with decisions made by the current self.

those choices, justifies state intervention to ensure people do not make decisions fatally compromising their future selves. Viewed this way, legal intervention that at first blush appears to adversely impinge on the freedom of the current self (current contributor), in fact promotes the freedom and autonomy of the future self (future beneficiary). In its broadest terms, the argument is that the future beneficiary is a fundamentally different person from the current contributor, who is exercising the power to direct plan investments. The future beneficiary is making no decisions. Therefore, the law is justified in attempting to protect the future beneficiary.¹⁵⁶

However, it is not necessary to make the argument in its broadest terms to justify regulation. We need not go so far as to create a metaphysical separation of a person into two selves to make the point that plan beneficiaries need legal protection. It is enough to recognize that the participant, in her capacity as current contributor, has different interests and different incentives than she does in her capacity as future beneficiary. There is something fundamentally different between an employee and a retiree, not merely a temporal difference, but an enormous change in circumstance giving rise to vast differences in interests and priorities between the person at the two points in time. Retirement creates new circumstances and these vastly changed circumstances justify regulation.

This is not an argument that requires us to completely nullify personal autonomy and self-determination. It is not a statement that it is always permissible to force people to do things we know are truly in their interest. It is, instead, an attempt to draw a middle ground between a Millisian notion of an autonomous self who is free to do what it wants to the self, and a communistic notion under which the government is completely paternalistic and responsible for making decisions over ostensibly personal matters. I emphasize this point because an extreme version of the position I am articulating might maintain any person making a decision in any moment makes a decision affecting a different person at

¹⁵⁶ I want to be clear that the argument here is not one based on myopia. It is not the claim discussed by Professor Sunstein and others that short-term costs prevent an individual from acting in her long-term interest. Although participants discount future benefit more than a rational economic actor would, making this a persuasive argument for interfering in certain plan choices, such as decisions about participation and contribution levels and decisions whether to take cash distributions upon pre-retirement terminations of employment. To the claim that the future beneficiary is a fundamentally different person from the current contributor who is exercising control, the basis of the current contributor's decision — myopia or otherwise — is irrelevant. See Sunstein, *supra* note 41, at 1164–66 (discussing problem of myopia); Deborah M. Weiss, *Paternalistic Pension Policy: Psychological Evidence and Economic Theory*, 58 U. CHI. L. REV. 1275, 1297–1300 (1991).

the future time,¹⁵⁷ justifying any law without regard to its impact on personal freedom. Here it is the vast change in circumstances created by the event of retirement, which allows us to go part way, distinguishing between present and future interests without obliterating personal freedom completely.

IV. ARGUMENTS FOR PATERNALISM REGARDING PARTICIPANT DECISIONS

Section III critiqued the underlying basis of section 404(c), arguing that participant-directed 401(k) plans offer only the illusion of control. Thus, Congress' basis for removing such plans from the protection of ERISA's fiduciary standards is faulty. In this section, I argue the law would be justified in acting to protect individuals from the consequences of their exercise of control even if meaningful control existed in such plans. Two arguments justify legal intervention. First, participants are unable make good decisions because of certain biases and heuristics affecting their decision-making ability. Second, poor participant decisions result in harm to third parties.

A. COGNITIVE BIASES

The liberty argument for allowing individuals to make their own decisions is based on the notion of individuals comprehending their own best interest and acting on it. If, in fact, individuals are either incapable of understanding their own best interests, or they are incapable of acting in their self-interest for one reason or another, it is easier to make a case for the government action to influence or mandate certain decisions.

That people engage in certain behavior different from what we might expect is not itself sufficient to make a case for legal intervention. For example, many employees do not save enough for their retirement.¹⁵⁸ Many employees elect to not participate in their employer's 401(k) plan¹⁵⁹ and many others who do participate take early cash-outs when they switch jobs in mid-career.¹⁶⁰ Failure to save may represent a

¹⁵⁷ For example Buddhists conceive of the person as a stream of moments of consciousness, without a static continuing ego, such that what is called the person at any given moment of consciousness is not the same as that person in the next moment of consciousness. See PETER D. SANTINA, *FUNDAMENTALS OF BUDDHISM* 123–31 (2001). This is not the sense in which I am distinguishing between the participant as current employee and the participant as future retiree, which is based on differences in circumstances.

¹⁵⁸ See *infra* note 176.

¹⁵⁹ Estimates of participation rates in 401(k) plans vary from 50% to 90%. See Stabile, *supra* note 14, at 80 (also noting that many employees who do participate in such plans fail to contribute the maximum amount permitted).

¹⁶⁰ *Id.* (citing Hewitt Associate findings that 68% of participants who switch jobs between the ages of 20 and 59 take cash distributions instead of rolling over their plan account balances).

deliberate decision by a rational person favoring present consumption over future consumption.¹⁶¹ Similarly, certain investment decisions unlikely to maximize retirement income, e.g., investing of an entire 401(k) portfolio in a guaranteed investment contract, may be explained as the product of a rational conservative investor who does not choose to risk a market downturn. Therefore, to make the case for intervention, one must be able to point to cognitive limitations or biases preventing employees from making rational decisions with regard to their 401(k) participation and investment.

Such biases certainly exist and their existence casts doubt on the notion of participant choice and control.¹⁶² As I have explored at greater length elsewhere,¹⁶³ participant decisions in 401(k) plans are often the product of deficient information, inadequate knowledge, and cognitive biases. Poor investment decisions reflect this.¹⁶⁴ Large numbers of participants, particularly women and minorities, invest too conservatively to amass a sufficient retirement nest egg.¹⁶⁵ Others behave too passively, making an initial asset allocation decision and never changing it.¹⁶⁶ Those participants who attempt to invest actively tend to respond too late to market signals.¹⁶⁷ Finally, participants invest far too heavily in em-

¹⁶¹ In economic terms, present consumption and future consumption are two different goods and a decision to prefer present consumption over future consumption is no less legitimate than a decision to forego present consumption (i.e. participate in a retirement plan) in favor of future consumption.

¹⁶² The concerns raised in this section about the inability of participants to make sound plan decisions also have implications for current proposals to implement President Bush's desire to permit workers to manage a portion of their Social Security benefits. See Danny Hakim, *401(k) Accounts are Losing Money for the First Time*, N.Y. TIMES, July 9, 2001, at A1 (also noting that many states are creating plans similar to 401(k) plans to allow government employees to manage their own pension money).

¹⁶³ See Stabile, *supra* note 14, at 86-94.

¹⁶⁴ See Zanglein, *supra* note 3, at 246-47 (citing statements of former SEC Chairman Beese and others regarding inability of participants to make good investment decisions).

¹⁶⁵ See *id.* at 238-44 (discussing conservatism of women and minority plan investors). As one commentator has noted, "The average participant is averse to the risk of principal loss from market fluctuation and not averse to principal loss from inflation . . . As a result, substantial portions of the participants' funds are allocated to 'safe' fixed income options and small portions to equities." Kathleen P. Utgoff & Theodore R. Groom, *The Regulation of Pensions: Twenty Questions after Twenty Years*, 21 J. PENSION PLAN. & COMPLIANCE 1, 11 (1995).

¹⁶⁶ See Benartzi & Thaler, *supra* note 99, at 6 (citing two studies of TIAA-CREF participants, finding the vast majority of participants make no changes to their portfolios); Investment Company Institute, *401(k) Plan Participants: Characteristics, Contributions and Account Activity*, ICI RESEARCH SERIES 6 (Spring 2000) (finding 60% of plan participants stick with their initial investment decision); Penelope Wang & Judy Feldman, *The 401(k) of the Future*, MONEY, Jan. 2000, at 82 (noting about 80% of 401(k) plan participants do not change their initial asset allocation).

¹⁶⁷ See, e.g., *Investments: 401(k) Participants Move Assets From Equities Into Fixed Income*, *Hewitt Says*, PENS. & BEN. REP. (BNA) (Oct. 2, 2001) (noting many participants responded to declines in the market by moving funds out of equities into fixed income options).

ployer securities.¹⁶⁸ The cognitive distortions producing these results—bounded rationality, bounded self-interest, optimistic bias and loss aversion¹⁶⁹—represent a form of market failure and present a strong justification for legal intervention. Nothing in the ERISA section 404(c) regulations addresses these concerns. The only relevant precondition to independent decision-making required by the regulations is the participant's legal capacity.¹⁷⁰ Legal capacity is obviously a necessary condition to optimal plan decision-making, but certainly not a sufficient one.

In the next subsection, I justify legal intervention based on harm to others, which is, admittedly, an easier case to make than the case for intervention to prevent harm to oneself. Nonetheless, numerous laws focus as much on a concern with harm to self as with harm to others.¹⁷¹ And in other cases, it is often unclear whether the legislature is acting to prevent harm to others or harm to self.¹⁷²

In contrast to ERISA's focus on employer abuse, the United States tax policy towards pensions is extremely paternalistic. The very existence of the tax subsidy for employer-sponsored retirement plans and individual retirement accounts is premised on the reality that most individuals will not save enough on their own to meet their needs in retirement.¹⁷³ Other provisions of the Internal Revenue Code ("Code"), such as those limiting plan alienation of pension benefits¹⁷⁴ and requiring trustee-to-trustee rollovers to discourage early cash-outs of pension distributions,¹⁷⁵ reinforce this notion. Therefore, when we consider the extent to which the law ought to interfere with 401(k) plan decisions, we are not

¹⁶⁸ See generally *supra* note 115.

¹⁶⁹ See Stabile, *supra* note 14, at 89-92 (discussing the biases impacting participant investment decisions).

¹⁷⁰ 29 C.F.R. §2550.404c-1(c)(2)(iii) (2001).

¹⁷¹ The examples that come most readily to mind are the so-called "sin taxes," which aim to prevent unhealthy lifestyles and promote consumer well-being. See 26 U.S.C. § 5001 (1994) (imposing a tax on all distilled spirits produced in or imported into the U.S.); 26 U.S.C. § 5701 (imposing taxes on cigars, cigarettes, and tobacco products).

¹⁷² Motorcycle helmet laws may be one such example. See *infra* note 183.

¹⁷³ See Weiss, *supra* note 156, at 1280 (discussing paternalistic nature of tax incentive scheme for retirement savings). The paternalism is especially evident in 401(k) plans, which do not even provide a tax-effective means of providing retirement income. Study findings suggest lower-income participants contributing in 401(k) plans may pay more in lifetime taxes than they would if they took the money invested in 401(k) plans and saved outside of the plan. See *Investments: Low-Income Participants in 401(k) Plans May Pay More in Lifetime Taxes, Study Finds*, PENS. & BEN. REP. (BNA) (Sept. 11, 2001). Therefore, the real purpose of a 401(k) plan is to create a forced savings vehicle.

¹⁷⁴ See 26 U.S.C. § 401(a)(13) (1994).

¹⁷⁵ See 26 U.S.C. § 401(a)(31) (1994). The fact that the new rollover rules were enacted as part of the Unemployment Compensation Amendments of 1992 may raise in the minds of the cynical the question whether Congress really thought trustee-to-trustee transfers would decrease cash-outs, or whether the amendments were a revenue-raising device. The legislative history accompanying the Act, however, suggests Congress was motivated by a desire to preserve retirement benefits. See 138 CONG. REC. S8177, 8180 (daily ed. June 15, 1992) (report

talking about whether to introduce paternalism into a system that fits cleanly in an area of individual choice. Rather, the question is whether to expand the paternalism already present in the law. It is, therefore, no great leap to suggest that the law, having put in place a system designed to ensure retirement security, take steps to ensure the system in place actually operates in such a way as to attain this goal.

Even for those people more comfortable with using the potential for employer abuse as a lynchpin for justifying legal intervention, the statutory regime created by section 404(c) is problematic. The widespread existence of cognitive biases allows employers to argue that any loss to a participant's account balance was caused by the participant's exercise of control, thus, as in *Unisys*, immunizing the employer's own fiduciary breaches.

B. SOCIAL HARM

Notwithstanding the foregoing, one might be willing to allow individuals the freedom to make their own decisions and to live with the consequences of their decisions when those consequences have no spillover effects on other persons. However, poor investment decisions by employees, as well as decisions by employees not to participate in 401(k) plans, and decisions by participants to cash out their account balances upon pre-retirement job terminations, are decisions that do have externalities. If employees retire with insufficient assets to support themselves during their retirement,¹⁷⁶ the government will be forced to step in and meet at least their basic needs. In the final analysis, the public as a whole will bear the consequences of individual participant decision-making. This will be no small weight to bear. Statistics show that American

on the Unemployment Compensation Amendments of 1992, prepared by Senate Committee on Finance).

¹⁷⁶ Benefits from an employer-sponsored pension plan are a significant component of retirement security. Most people save very little on their own outside of their retirement plans. See Stabile, *supra* note 37, at 78 (noting failure of most Americans to save outside of their retirement plans); Dallas L. Salisbury et al., *Retirement Confidence Survey 2000*, EBRI ISSUE BRIEF No. 222, 6 (June 2000) (noting that although the proportion of survey respondents who are saving for retirement has increased, the amounts saved are "generally unimpressive"). Social Security benefits are unlikely to be sufficient to fill the gap. See, e.g., Kathryn L. Moore, *Raising the Social Security Retirement Ages: Weighing the Costs and Benefits*, 33 ARIZ. ST. L.J. 543, 544 (2001) (observing that the Social Security system faces a serious funding deficit and noting the prediction of the OASDI Board of Trustees that "unless corrective action is taken, Social Security benefit payments will exceed dedicated tax revenues by the year 2015, and the Social Security program will become insolvent—unable to pay promised benefits in full—by the year 2037"); Jack VanDerhei, *The Changing Face of Private Retirement Plans*, EBRI ISSUE BRIEF No. 232 (Apr. 2001) ("Social Security's projected long-term financial shortfall could result in a reduction in the current-law benefit promises made to future generations of retirees."). Inadequate retirement income is a particular worry for lower income employees, who are both unlikely to have significant private savings and have lower Social Security earnings and, therefore, benefits.

workers both have longer life expectancies¹⁷⁷ and are retiring earlier.¹⁷⁸ Therefore, the gap between what workers save and what they will need during their retirement is potentially very large.¹⁷⁹

The alternative to people retiring with insufficient assets is a different type of social harm. Employees who feel they do not have sufficient funds accumulated to see them through their retirement years may simply not retire. This results in the retention of less motivated employees for employers, a loss of new jobs for new employees, and the prospect of advancement for others.¹⁸⁰ In either case, there are externalities present, thus individual liberty is not the only interest at stake here.

Consequently, there is a social justification for government intervention to prevent, or at least discourage, employees from making bad decisions, i.e. decisions that will leave them with insufficient retirement assets. Protecting the interest of future generations is a societal interest.¹⁸¹ This brand of paternalism is not difficult to justify,¹⁸² and numer-

¹⁷⁷ See, e.g., Jonathan Barry Forman, *Federal Tax Policy in the New Millennium: Universal Pensions*, 2 CHAPMAN L. REV. 95, 101 (1999) (citing statistics showing life expectancy for males has increased from 61.4 years to 73.2 years between 1940 and 2000); Joint Economic Committee, *Social Security in the 21st Century*, 2000 C.I.S. J. Print 84220 (citing statistics showing that life expectancy for males who reach the age of 65 has increased from 12.1 years in 1930 to 15.9 years in 1997).

¹⁷⁸ See, e.g., Forman, *supra* note 177, at 101 (citing statistics showing that the average age for the commencement of Social Security benefits has decreased from 68.7 years to 63.6 years from 1940 to 1995); Moore, *supra* note 176, at 612 (citing statistics showing that in 1995 almost 60% of workers chose to commence Social Security benefits at the age of 62).

¹⁷⁹ Moreover, increasingly fewer employees benefit from retiree health insurance from their employers, with the result that retirees' increased medical costs will be a further drain on their resources. See Hewitt Associates, *Retiree Health Coverage: Recent Trends and Employer Perspectives on Future Benefits*, in REPORT BY HEWITT ASSOCIATES FOR THE HENRY J. KAISER FAMILY FOUNDATION, 3-4 (Oct. 1999) (finding a 13% drop in the share of large employers offering retiree health coverage to retirees age 65 and older between 1991 and 1998 and a 12% drop in coverage of retirees younger than age 65). In addition, those companies continuing to provide retiree health coverage require increasing contributions from retirees and limit the benefits provided under such plans. See *id.* at 6. Many companies have also tightened the eligibility requirements for their plans. See *id.*

¹⁸⁰ Cf. Patricia E. Dilley, *Taking Public Rights Private: The Rhetoric and Reality of Social Security Privatization*, 41 B.C. L. REV. 975, 1052-53 (2000) (arguing the entitlement to Social Security income is an important tool for accomplishing the social policy goal of retirement and social stability; Social Security provides a necessary means of moving people out of the workforce and into retirement).

¹⁸¹ See Weiss, *supra* note 156, at 1290-91 (discussing justification for interference with individual savings decisions based on fact that "savings affects the welfare of future generations, but those generations play no role in determining today's savings. Thus, the national savings level may be too low to protect the interest of future generations.").

¹⁸² See Sunstein, *supra* note 41, at 1130 ("It may generally be agreed that if actions that gratify private preferences produce 'harm to others,' governmental intervention is appropriate.").

ous examples exist of seemingly paternalistic laws justified by their aim to reduce social costs.¹⁸³

Since we are talking about imposing obligations on corporations to ensure their plans are structured to achieve this societal goal, it is particularly easy to justify legal regulation in this area. Corporations, after all, are creations of society.¹⁸⁴ Even if one is unwilling to go so far as to accept Robert Dahl's notion of corporations being social enterprises existing to serve public purposes,¹⁸⁵ corporations do exist only because the law gives them statutory recognition. Corporations have no rights except insofar as the law gives them such. An imposition on corporate employers of an obligation to take steps ensuring their employees retire with sufficient income is not a difficult case to make. This is especially so since the law provides employer pension plans with such favorable tax treatment, at a considerable monetary cost. If notions of corporate social responsibility imply that public corporations "have an obligation to contribute to the betterment of society in a manner distinct from the maximization of corporate profit,"¹⁸⁶ those same notions demand that corporations adopt a more responsible attitude toward promoting the retirement security of their own employees.

V. HOW SHOULD THE LAW INTERVENE?

Justification for legal intervention in the decisions made by 401(k) plan participants does not tell us how the law should intervene or whether it can intervene effectively. Furthermore, legislative or regulatory interventions may promote unintended consequences, cautioning that no step should be taken lightly.

Numerous proposals have been advanced by various commentators to improve the likelihood participants in 401(k) plans will retire with sufficient assets. These range from proposals for the invention of new

¹⁸³ One example is that of motorcycle helmet laws. *See, e.g.*, CAL. VEH. CODE § 27803(a) (West 2002); TEX. TRANSP. CODE ANN. § 661.003(a)(2) (Vernon 2002).

¹⁸⁴ *See* David Millon, *Frontiers of Legal Thought I: Theories of the Corporation*, 1990 DUKE L.J. 201, 206 (1990) (noting a corporation is created by operation of law, yet often granted similar rights to those of a natural person (citing J. ANGELL & S. AMES, TREATISE ON THE LAW OF PRIVATE CORPORATIONS AGGREGATE (10th ed. 1875))).

¹⁸⁵ *See* ROBERT A. DAHL, AFTER THE REVOLUTION?: AUTHORITY IN A GOOD SOCIETY 80-87, 100, 102 (Rev. ed. 1990); Robert A. Dahl, *A Prelude to Corporate Reform*, 1 BUS. & SOC'Y REV. 17 (1972).

¹⁸⁶ Faith Stelman Kahn, *Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 UCLA L. REV. 579, 629 (1997). *See* Vincent M. DiLorenzo, *Equal Economic Opportunity: Corporate Social Responsibility in the New Millennium*, 71 U. COL. L. REV. 51 (2000) (discussing the "evolving societal view that recognized the fairness of imposing social obligations on private enterprises."); David L. Engel, *An Approach to Corporate Social Responsibility*, 32 STAN. L. REV. 1 (1979).

investment products designed to guarantee a certain level of returns;¹⁸⁷ proposals to provide insurance for participant accounts;¹⁸⁸ proposals to improve participant education in various ways;¹⁸⁹ proposals to cap investments in certain options, such as employer securities;¹⁹⁰ and proposals to engage in a wholesale revision of ERISA.¹⁹¹ The range of proposals suggests a lack of consensus about how best to promote retirement security in a 401(k) plan world.

The purpose of this section is not to advocate a comprehensive prescription for change, but rather to identify a starting point and raise some of the issues necessary in deciding how the law should intervene. I have elsewhere already indicated areas in which I think further research is necessary before any action is taken.¹⁹²

A reasonable starting point is section 404(c). Section 404(c) lacks a firm theoretical basis because control by participants is illusory. Because of context dependence, participants never exercise sufficient control to justify the conclusions section 404(c) draws based on the exercise of control. Additionally, the ultimate beneficiary never exercises control because of the significant change in circumstances wrought by retirement. Moreover, the concept of control should not be the decisive factor, even if meaningful control did exist, because of problems with participant decision-making and the adverse social consequences of poor decision-making.

The foregoing suggests the correct step to take, *theoretically*, is eliminating section 404(c). Having destroyed the conceptual basis for the statutory provision, rather than adopting specific rules such as percentage limitations on acquisitions of employer securities, section 404(c) should be abolished. Doing so would have two effects. First, it would impose fiduciary standards on participants. Second, it would create potential liability on the part of employers.

¹⁸⁷ See Jeffrey N. Gordon, *Employees, Pensions, and the New Economic Order*, 97 COLUM. L. REV. 1519 (1997) (proposing creation of a "pension equity collar" that would guarantee a minimum return close to the longterm average equity return); ZVI BODIE, RETIREMENT INVESTING: A NEW APPROACH, (Pension Research Council, Working Paper 2001-8, 2001) (proposing development of inflation-protected life annuities).

¹⁸⁸ See generally Jefferson, *supra* note 85 (proposing establishment of a system of insurance protection for defined contribution plans similar to that which presently exists for defined benefit plans).

¹⁸⁹ See generally Zanglein, *supra* note 3 (outlining comprehensive approach to investment education to enable participants to make better decisions).

¹⁹⁰ See Medill, *supra* note 45, at 75; Stabile, *supra* note 37, at 87-89.

¹⁹¹ See PAMELA PERUN & C. EUGENE STEUERLE, OCCASIONAL PAPER NUMBER 4, THE RETIREMENT PROJECT, ERISA AT 50: A NEW MODEL FOR THE PRIVATE PENSION SYSTEM (Mar. 2000) (criticizing piecemeal modifications of ERISA).

¹⁹² See Stabile, *supra* note 14, at 95-105.

With regard to the first of those consequences, just as Congress chose to impose a set of fiduciary standards on those who manage defined benefit pension plan assets, it may be more appropriate and beneficial to impose such standards on participants¹⁹³ rather than attempting to establish a set of specific rules to govern their investment decisions. Since participants vary tremendously in their personal circumstances (regarding such matters as amount of outside resources for retirement, income level, years to retirement, etc.), it may be difficult to create rules that would be appropriate to all participants in all circumstances.¹⁹⁴ Thus, the benefit of standards becomes clear.

While elimination of section 404(c) may sound logical, pragmatic issues require consideration. First, although the absence of section 404(c) would make a participant who made her own plan investment decisions a fiduciary, subject to the standards in ERISA governing fiduciary behavior, it is unclear how one would enforce those standards. The participant is unlikely to sue herself in the event of a violation.¹⁹⁵ It is even less likely the DOL would monitor such violations. Thus, there may be no practical means of enforcing adherence to the standards.¹⁹⁶

Second, practical consequences will clearly flow from taking away the employer's protection from co-fiduciary liability for participant losses. Putting potential co-fiduciary liability back on the table would risk a lawsuit alleging employer participation in a breach every time a participant suffered a significant loss. There are several possible employer responses to fear of such lawsuits, not all of which are positive. One possible employer response is the elimination of participant direction of 401(k) plans. Employers concerned with facing liability might decide a better alternative is to make the investment decisions for participants. In making this decision, they would be forced to weigh potential liability against the participants' desire to direct their plan investments.¹⁹⁷ In balancing those concerns, they might consider the preference for self-direction may be modifiable. Surveys by Richard Thaler

¹⁹³ At first blush, it may seem strange to cast participants as fiduciaries over their own money. However, once one phrases it as forcing the current participant to safeguard the assets of the future retiree, there is less reason to be philosophically bothered by such a designation.

¹⁹⁴ See Russell B. Korobkin, *Behavioral Analysis and Legal Form: Rules v. Standards Revisited*, 79 OR. L. REV. 23, 36 (2000) (noting that even complex rules may fail to take into account all of the factual variations that may arise).

¹⁹⁵ The experience with the Code's prohibited transaction requirements provides evidence of this problem. See 26 U.S.C. § 4975 (1994). IRA owners obviously do not self-report their violations to the IRS.

¹⁹⁶ It may be that the perceived need to satisfy external standards may have some beneficial impact on participant decisions, but that assumes that participants become familiar with the standards and have them in mind when they make plan decisions.

¹⁹⁷ See Medill, *supra* note 45, at 19 (citing EBRI survey finding that 62% of survey respondents who contributed to a plan prefer making their own investment decisions); Paul Yakoboski, *Participant-Directed Retirement Plans Today and Critical Issues for Tomorrow*, in

and Shlomo Benartzi have demonstrated participants who prefer to direct their own investments actually prefer the distribution of returns suggested by a portfolio selected by a professional asset manager rather than the one they selected themselves.¹⁹⁸ Participants might very well be persuaded that they do not benefit from the ability to direct their own investments. Thus, a good result occurs if elimination of section 404(c) leads us back to a situation where professional asset managers rather than individual plan participants make pension plan investment decisions.

A second possible employer reaction to potential liability for losses occasioned by participant decisions is to provide more extensive investment advice and education to plan participants and actively monitor decisions made by participants. Evidence suggests educational efforts by employers have a positive effect on decisions whether to participate in a 401(k) plan and how much to contribute to the plan.¹⁹⁹ However, the real question remains whether it is possible to positively influence, by education or otherwise, the cognitive biases influencing investment decisions. First, certain employee biases may not be very susceptible to intervention. To the extent certain investment decisions reflect operation of optimistic biases, empirical studies have demonstrated such biases are not easily reduced through attempts at manipulation.²⁰⁰ To the extent other decisions, for example, decisions to heavily invest in employer securities, reflect loyalty to the employer, it may be difficult to try to manipulate the behavior responsible for the investment decision without creating undesirable consequences regarding employee loyalty. Second, recent empirical evidence suggests that although plan participants who receive financial education say they intend to make changes in their investment allocations, very few of them actually do.²⁰¹

WHEN WORKERS CALL THE SHOTS: CAN THEY ACHIEVE RETIREMENT SECURITY 9, 20 (Dallas L. Salisbury ed. 1993).

Effectively, having given participants the ability to direct their plan investments, the law and employers have created a sense of entitlement among participants to that plan design. The operation of what has been labeled the endowment effect may make it very difficult to persuade participants to be happy about giving up the entitlement. See Christine Jolls et al., *A Behavioral Approach to Law and Economics*, in *BEHAVIORAL LAW AND ECONOMICS* 13, 19 (Cass R. Sunstein ed. 2000).

¹⁹⁸ See Benartzi & Thaler, *supra* note 99, at 13–17.

¹⁹⁹ See ROBERT L. CLARK & MADELEINE B. D'AMBROSIO, TIAA-CREF WORKING PAPER, FINANCIAL EDUCATION AND RETIREMENT SAVINGS 4–5 (June 2001) (discussing studies finding positive effect of education on participation and contribution decisions).

²⁰⁰ See Neil D. Weinstein & William M. Klein, *Resistance of Personal Risk Perceptions to Debiasing Interventions*, 14 *HEALTH PSYCHOL.* 132 (1995) (reporting on results of several studies which failed to reduce optimistic biases).

²⁰¹ See James J. Choi et al., *Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance*, NBER WORKING PAPER SERIES, WORKING PAPER 8655, at 5, 28–31 (Dec. 2001), available at <http://www.nber.org/papers/w8655>.

Notwithstanding these difficulties, an employer trying to avoid liability is more likely to make an effort to provide advice and education to overcome participants' limitations than one with no such fear of liability. Moreover, at least some participants will benefit from this effort. Thus, although to a lesser extent than eliminating of participant direction, providing more extensive investment education and advice would improve the current state of affairs.

Another significant employer reaction arising from the elimination of 404(c)'s protection against employer-co-fiduciary liability is abandoning 401(k) plans altogether.²⁰² Any suggestion for pension reform must be assessed in light of the reality that pension plan sponsorship is voluntary. ERISA imposes significant substantive regulation on pension plans, but leaves the decision whether to offer a pension plan in the first place to employers. One possible reaction by employers to the possibility of co-fiduciary liability is to terminate their 401(k) plan. For small employers, that would likely mean no pension plan at all, since small employers find the costs of defined benefit plans prohibitive.²⁰³

While the theoretical possibility of plan termination exists, I do not believe it to be the likely result of elimination of section 404(c). Corporations competing for talented and skilled employees have no choice but to offer pension plans in order to compete with competitors offering such plans.²⁰⁴ This makes it more likely employers will continue their plans, albeit perhaps without participant-direction.

Nevertheless, the possibility of plan termination by small employers exists. It may be desirable, notwithstanding the absence of a theoretical basis for section 404(c), to proceed with caution. While ongoing research continues to attempt to more accurately predict employer reaction to the fear of co-fiduciary liability, less drastic steps could be taken in the interim. Several possibilities should be considered.

A significant interim step would require employers to establish a default investment allocation for participants selected by a professional asset manager and give employees the ability to affirmatively elect to modify the default allocation. This would preserve the ability of individuals who wish to exercise independent decision-making over their accounts. However, as the findings of Brigitte Madrian suggest, many

²⁰² Opponents of amendments to ERISA frequently raise this concern. As Professor Colleen Medill has observed, the fear of plan termination has often stymied attempts at pension reform. Colleen E. Medill, *Targeted Pension Reform*, 27 J. LEGIS. 1, 3 (2001).

²⁰³ See Zanglein, *supra* note 3, at 227-30, n.11 (2001).

²⁰⁴ *Id.* at 49 (noting that publicly traded corporations compete in a national labor market for a limited pool of skilled employees and to attract such workers, employers must offer pension plans). Professor Medill recognizes the difference between publicly traded corporations and smaller owner-employee businesses, suggesting the risk of termination is greater in the latter. *Id.*

participants will stick with the professionally selected investment decisions,²⁰⁵ representing an improvement over decisions made by most participants.

To accompany the foregoing change, section 404(c) could be modified to mandate the provision of meaningful participant education and advice as a precondition to receiving the protection offered by the section. Alternatively, ERISA could simply require all participant-directed plans (whether or not intended to satisfy section 404(c)), provide such education and advice. In either case, the employer should be viewed as a fiduciary in providing such education and advice. At the same time, the law should disallow those who provide investment options and other services to also provide investment advice. Given the limitations of participant education, this step alone would be insufficient. However, improved education should be part of the solution.

Finally, Congress should consider specific changes that would cabin participant choice, such as the adoption of limitations on acquiring employer securities. Standing on their own, such specific changes are likely to be ad hoc and only address some of the individual symptoms of the problem rather than the problem itself. However, they represent an interim step, while the impact of more drastic action is considered.

CONCLUSION

Professionally managed defined benefit pension funds are becoming relics of the past. For increasing numbers of employees, their 401(k) plan is their most meaningful source of retirement income. Retirement security of today's workers depends on how their 401(k) plan contributions are invested. Ensuring workers have adequate retirement income is important not just to those workers, but also to society as a whole.

Congress' decision to allow 401(k) plan participants to manage their retirement assets as they choose is a misguided one. The "control" that theoretically justifies leaving participants to their own devices is illusory. Not only do employers retain significant influence over participant choices, but also the ultimate beneficiary of the 401(k) plan account, in fact, exercises no control over plan investments. This lack of control, combined with cognitive biases adversely affecting participants' decision-making ability, means that Congress should reconsider the judgment evidenced in section 404(c) of ERISA.

One thing to consider is eliminating section 404(c), a step appearing as a drastic approach to many people. Less radical changes are easier to accept, such as requiring employers to provide education, or establishing some type of insurance cushion for participant account balances. I have

²⁰⁵ See generally *supra* note 76 and accompanying text.

argued that section 404(c) lacks a sound philosophical basis. The only reason to keep the section in the statute is the pragmatic concern regarding how employers will respond to the elimination of protection against co-fiduciary liability. Although I believe it is much more likely that employers will respond in a way that retains 401(k) plans in some modified fashion than that they will terminate their plans, the risk of termination justifies proceeding cautiously. One or more interim steps should be adopted, at least as a preliminary matter, while more research is undertaken regarding the employer response to potential liability.