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## **DECONSTRUCTING ERISA**

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**I. Introduction:** In recent years, the term “401k” has become the popular symbol of the private pension system. As 401k-type plans - where participants decide how much to save for retirement every year - have increased in popularity, they seem to be the most revolutionary change in the private pension system. To many pension professionals, however, that honor belongs not to “401k” but to “404c”. For almost a decade, a natural experiment has been occurring in the private pension system. In an effort to reduce their fiduciary exposure, millions of plan sponsors have utilized ERISA § 404(c) to transfer investment responsibility to participants.<sup>1</sup> In a 404c plan, participants decide how their retirement plan accounts will be invested among the investment options available under their plan. Millions of plan participants, often without the benefit of investment advice or education, now manage their own retirement assets. Because this development has coincided with a bountiful stock market, its significance has not yet been understood. But the law suits are coming, and they promise to transform a rather sleepy section of ERISA into that phrase so familiar to lawyers - “a trap for the unwary.”

There is a general recognition that the private pension system today has two primary problems. There are too many rules, and there are too few plans. Pension laws *are* complex. The private pension system contains layer after layer of tax rules constraining employer behavior over how much they may pay in benefits and to whom. Appendix A below provides a summary of just some of those rules. It is also true that millions of American workers, particularly low-income workers, do not have an employer-sponsored retirement plan.<sup>2</sup> In a previous paper we have argued that the extraordinary complexity of pension plan arrangements is one major stimulus for change in the private pension system.<sup>3</sup> Where the government has failed to simplify, the private sector has responded in its own way. The movement away from defined benefit plans to simpler defined

contribution arrangements and the merger of defined benefit and defined contribution plan features through the development of new plan forms such as cash balance plans represent just two such responses.

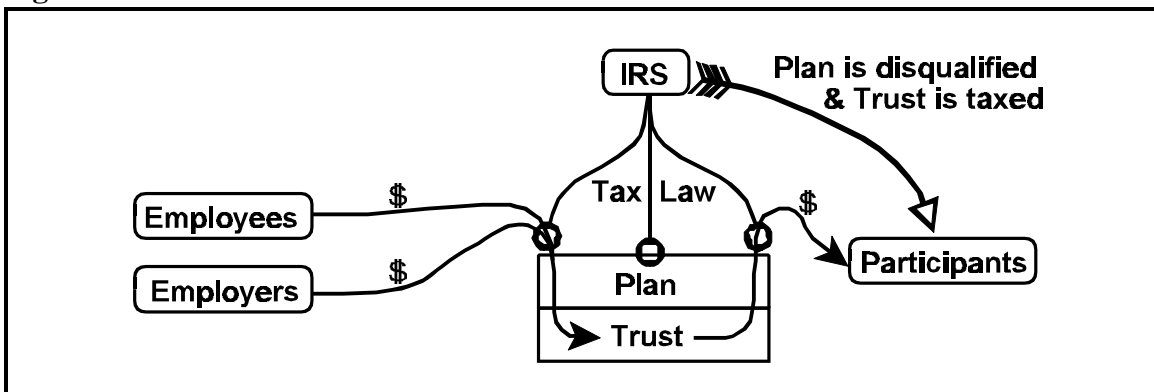
But many other powerful forces are also at work. One is that the classic defined benefit structure simply has too much uncertainty in its liability. This is not merely an issue of fluctuating stock markets but of benefit accruals that vary widely with such factors as inflation and the rate of retention of employees. Such uncertainty not only adds to risk, it can constrain the development of the modern firm, whether successful or unsuccessful. The very existence of a defined benefit plan affects mergers, acquisitions, spin-offs, and a whole host of other potential business combinations and reorganizations. The notion that a firm can easily absorb downside risks in pension plans is also open to question. If the shortfall is large enough, there are not enough profits available. Then the additional funding would have to come from higher charges to customers or lower wages and salaries for employees. In theory, however, a firm cannot remain competitive if it is charging more and paying its employees less. Defined contribution plans and, to a great extent, cash balance plans where liability is certain remove this type of risk for shareholders and employees alike.

The needs of the modern workforce also cry out for a different style of plan. The classic defined benefit structure engaged in a type of age discrimination against both the oldest employees (who could garner little or nothing additional in present value of pension benefits) and the youngest employees (whose benefits were often worthless unless they happened to stay with the firm for several decades). With rising demands for skilled labor no longer being so easily met by the influx of women into the workforce, it was not surprising that adaptations were made toward a defined contribution structure — where greater shares of compensation could be paid the young and the old.

In this paper we wish to examine an additional aspect of this trend, one that has been given scant attention in the literature - the response of employers to ERISA rules related to fiduciary liability. This private sector has recently responded to the liability created by those rules by transforming its defined contribution plans into 404c plans. But as litigation over self-directed plans becomes more wide-spread, this response may prove to be counter-productive. Employers will then search for other means - including plan termination - to reduce their exposure. In anticipation of such a development, the paper suggests one way in which ERISA might be restructured to reflect the diminished role played by most employers today in their defined contribution plans. It presents one new model for ERISA where the operational and investment functions of today's employer plan are shifted to personal plans and employers are freed to focus on what they do best: make contributions on behalf of their employees.

**II. Before There Was ERISA.** Before ERISA was enacted some twenty-five years ago, as Figure 1 below indicates, the regulation of pension plans was modest in scope.

**Figure 1. The Pre-ERISA Plan**



By today's standards, the rules applied to pension plans were minimal, and they almost exclusively originated in the Internal Revenue Code ("Code"). The central requirement a pension plan had to meet was that it was "qualified" - that is, that it satisfied Code rules for special tax treatment.<sup>4</sup>

Internal Revenue Code §§ 401(a)(1)-(10) contained most of the relevant rules governing contributions, and those rules were largely intended to make at least some of those special tax benefits flow to the rank and file as well as executives. Because taxation of distributions was always an important issue, the Code also contained some elaborate provisions describing when and how distributions of benefits from qualified plans would be taxed.<sup>5</sup>

But the Code contained few rules for how plan contributions were to be managed and invested. As a qualification requirement, contributions and their earnings had to be held in a trust separate and apart from the other assets of the plan sponsor. The Code did require that trust assets be held for the “exclusive benefit of employees and their beneficiaries” until all plan liabilities were satisfied but the investment implications of that rule were never well-developed.<sup>6</sup> The Code did not set explicit standards for the investment of trust assets. The relevant pension regulations gave trustees wide discretion over how those assets should be invested, providing only that

“no specific limitations are provided in section 401(a) with respect to investments ... generally, the contributions may be used ... to purchase any investments permitted by the trust agreement to the extent allowed by local law.”<sup>7</sup>

In some ways, the Code was more explicit on how trust assets should *not* be invested. It created some special rules for investments in employer securities and, under Internal Revenue Code § 503(b) which then applied to most pension plans, forbade plan sponsors, among others, from using plan assets in certain types of transactions that involved conflicts of interest and self-dealing.<sup>8</sup>

Any penalties for violating pre-ERISA pension law were largely tax-related and imposed on the plan. The Internal Revenue Service was the primary federal regulator of pension plans, and its mission has always been the enforcement of the tax qualification rules. Under those rules, the Service had no discretion in the case of violations. The consequence was immediate plan disqualification; the

trust lost its tax-exempt status; and participants were taxed on their vested benefits in the plan.<sup>9</sup> It seems extraordinary today but participants had no effective legal means to protect their benefits from the actions of plan officials or to seek redress from those responsible for injuring the plan, even though they alone bore the consequences of plan disqualification.<sup>10</sup>

**III. ERISA's contribution.** The passage of ERISA was largely inspired by the bankruptcy of the Studebaker Company in 1963 whose pension plan also failed, defeating the retirement expectations of thousands of workers. The purpose of ERISA was to secure the pension promise - not only by adding new protections for participants' benefits under plan rules but also by assuring that sufficient plan assets would be available to pay promised benefits. In doing so, it fundamentally changed the organization and administration of pension plans. ERISA added two new major players: plan participants and the Department of Labor. It also created a comprehensive legal structure to regulate the behavior of those charged with administering plans and managing plan assets.

The effect of ERISA's passage was both evolutionary and revolutionary. First, the tax rules that applied to coverage, participation, funding and benefit accrual were considerably strengthened by new labor law provisions. Plan participants were also given legal rights to receive information about the rules of the plan and their benefits. ERISA requires plan officials to provide this information routinely and imposes civil and criminal penalties on plan officials who failed to do so.<sup>11</sup>

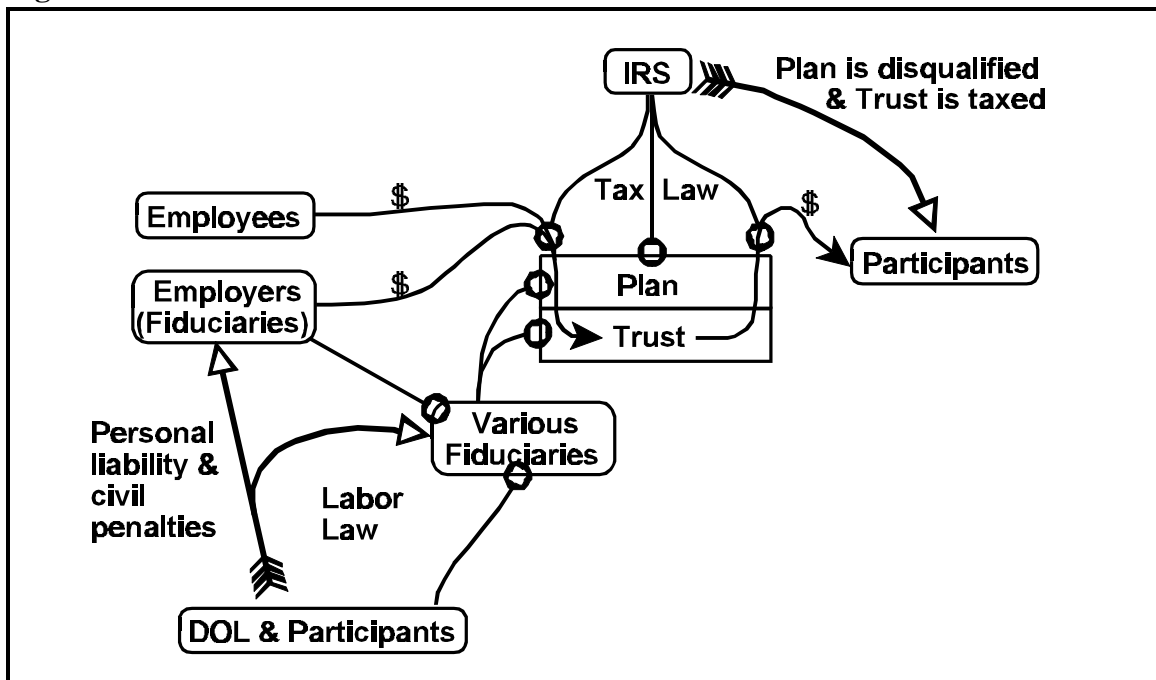
Second, ERISA created a new body of law regulating the management and investment of plan assets. The regulatory structure it built has the following key elements:

- # plan and asset management functions entail fiduciary responsibilities<sup>12</sup>
- # each plan must name the responsible parties ("named fiduciaries") charged with managing the operation of the plan and its assets<sup>13</sup>

- # the term “fiduciary” means anyone with “any discretionary authority or control” over plan management or assets or who renders investment advice with respect to plan assets for a fee<sup>14</sup>
- # a fiduciary must act for the “exclusive purpose” of providing plan benefits and minimizing plan expenses<sup>15</sup>
- # a fiduciary who breaches “any of the responsibilities, obligations or duties imposed upon fiduciaries” is personally liable to make the plan whole for each breach<sup>16</sup>
- # fiduciaries can also be liable (“co-fiduciary liability”) when other fiduciaries breach their duties<sup>17</sup>
- # plan participants may bring civil actions to enforce their rights, recover benefits and obtain relief for breaches of fiduciary duty<sup>18</sup>
- # the Department of Labor is empowered to bring actions for breach of fiduciary duty and to enjoin any act or practice violating ERISA.<sup>19</sup>

Figure 2 below illustrates how the fiduciary structure created with ERISA changed the private pension system.

**Figure 2. The Post-ERISA Plan**



From a legal perspective, it is significant that ERISA imposed fiduciary duties on plan management and investment functions and those who performed them. The term “fiduciary” involves not just the obligation to perform certain functions but also to perform them according to the highest standards of care. A fiduciary relationship differs from the usual contractual relationship where each party makes various promises to the other and is liable for the monetary value of a promise it breaches. The essence of a fiduciary relationship is to assume responsibility for the affairs of others and to act on their behalf and in their best interest. To be a fiduciary is therefore analogous to being a trustee, and fiduciaries must perform their duties with the utmost good faith and fidelity. If fiduciaries breach their duties, they are typically required to make those for whom they are responsible “whole”, that is, to place them in the position they would otherwise have been if no breach had occurred. A fiduciary breach therefore often results in much greater financial liability than a contractual breach.

Besides these general principles, ERISA incorporated additional standards that wove a tight net of responsibility around those fiduciaries involved in the investment of plan assets. Under ERISA § 404(a), the guiding principle for fiduciaries is that they must act prudently from both a procedural and substantive point of view.<sup>20</sup> Fiduciaries are judged not so much on the outcome of a particular investment decision but on whether they used appropriate methods to evaluate its merits when making any decision, according to standards set forth in regulations.<sup>21</sup> ERISA also imposes an “exclusive benefit” standard on plan fiduciaries, requiring them to consider only the interests of participants when making investment decisions. As one court has expressed it, this standard requires fiduciaries to act with “an eye single” to the interests of participants when dealing with plan assets.<sup>22</sup> Fiduciaries must also diversify plan investments to minimize the risk of large losses and avoid specified prohibited transactions that involve conflicts of interest and self-dealing.<sup>23</sup>

In the normal case, the plan trustee bears primary fiduciary responsibility for the investment of plan assets. ERISA § 403 requires that all plan assets be held in trust and assigns plan trustees the “exclusive authority and discretion to manage and control the assets of the plan.” Plan trustees are either named in the plan or trust instrument directly or appointed by a named fiduciary. There are only three permissible exceptions. First, a named fiduciary can retain investment authority in which case the trustees are merely conduit or “directed” trustees with no fiduciary responsibility.<sup>24</sup> Second, a named fiduciary can appoint an investment manager to manage plan assets, in which case the trustee is not a fiduciary with respect to those assets.<sup>25</sup> The named fiduciary, however, retains responsibility for all such appointments and must monitor the performance of the investment manager carefully to assure compliance with ERISA standards. Third, ERISA § 404(c) provides a special exception for self-directed plans, namely that

in the case of [a defined contribution plan] ... which provides for individual accounts and permits a participant ... to exercise control over assets in his account, if a participant ... exercises control over the assets in his account (as determined under regulations of the Secretary) - (A) such participant ... 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 ... for any loss, or by reason of any breach, which results from such participant’s ... exercise of control.

A self-directed plan that satisfies the requirements of ERISA § 404(c), then, provides plan fiduciaries with at least some relief from their normal fiduciary duties and liability.

The primary effect of the reforms brought about by ERISA is that there is always at least one individual or entity - a named fiduciary, trustee, or investment manager - responsible for how the assets of a plan are invested. That responsible party is subject to a strict code of conduct and answerable to plan participants, the Department of Labor and the courts for the investment

performance of plan assets. The consequences of a failure to satisfy ERISA's requirements are personal liability and financial penalties. Being an ERISA fiduciary, particularly of plan assets, is very serious business.<sup>26</sup>

In most cases, such fiduciary responsibility ultimately comes to rest directly on the company sponsoring the plan or indirectly through its officers or its employees. Unless they have active responsibility for investing plan assets, most professional trustees insist on a "directed" relationship in which their responsibilities are purely custodial to minimize their fiduciary exposure. Investment managers limit their responsibility over the assets they manage as much as possible. But even if it appoints an investment manager or a trustee willing to assume fiduciary responsibility, a fiduciary who is generally the plan sponsor remains responsible for monitoring their performance. If the fiduciary fails to act when necessary to protect the interests of plan participants, it will be liable for a fiduciary breach.

**IV. The 404c Regulations.** The new fiduciary duties imposed by ERISA did not immediately become problematic for plan sponsors. Litigation, when it came, largely focused on the performance of the professional advisors typically hired to manage the large pools of assets found in defined benefit plans. The Department of Labor frequently exercised its new authority to pursue breaches of fiduciary duty by trustees and investment managers, and those cases often involved technical breaches such as violations of the prohibited transaction rules.<sup>27</sup> Little case law developed applying the new fiduciary rules to defined contribution plans. Not even the stock market crash in 1987 resulted in many lawsuits by either the Department of Labor or plan participants.

In addition, few plan participants exercised their newly-granted rights to challenge the management of assets in their plans. This was a predictable result. While ERISA gave participants the right to sue, the statute also included some features almost guaranteeing that litigation would be a participant's last resort. For example, the typical ERISA claim - a claim for individual benefits involving only a small amount of money - is not attractive to most litigators. A participant can win at most the benefit to which he or she is entitled.<sup>28</sup> ERISA does not permit punitive damages or damages for pain and suffering and effectively preempts state laws that do.<sup>29</sup> Attorneys' fees are rarely awarded so a participant either pays for litigation out of pocket or through any recovery. As a result, the passage of ERISA did not lead to a big increase in fiduciary litigation by plan participants. In addition, a critical element in support of such litigation never developed: there is no plaintiffs' bar dedicated to pursuing ERISA claims.

But developments in the last twenty years promise to change this. Today defined contribution plans - not defined benefit plans - dominate the private pension system.<sup>30</sup> Participants are much more knowledgeable about their defined contribution plan benefits. They understand better how their benefits grow and the significance of investment performance for that growth. Employees have also come to assume much of the responsibility for funding their own pensions through 401k and 401k-type plans. The Department of Labor reports, for example, that "the percentage of total [defined contribution plan] contributions made by plan participants has been steadily increasing over the last decade and in 1996 was 16% higher than employer contributions."<sup>31</sup> Employers still make contributions or provide subsidies to other compensatory arrangements - such as defined benefit plans and stock purchase or stock option plans. But participants have increasingly responded to the

opportunity presented by 401k plans to make their own decisions about retirement savings - even though they receive fewer tax advantages for their contributions than do their employers.<sup>32</sup> And, increasingly, participants have assumed responsibility for the investment performance of their plan accounts. This last change is directly attributable to a single event that occurred in 1992 - the issuance of final regulations under ERISA § 404(c).

As noted above, when a defined contribution plan permits participants to exercise investment control over their accounts, ERISA § 404(c) relieves fiduciaries of some of their usual investment responsibilities. The private pension system had always had some self-directed plans but their status as 404c plans was unclear for many years. ERISA required the Department of Labor to issue interpretive regulations defining key terms in the statute, and the Department of Labor takes the position that compliance with its regulations is the exclusive means for obtaining 404c protection. Once the regulations were issued, fiduciaries of self-directed plans could finally take some concrete steps to obtain 404c protection.

The regulations themselves seem straightforward. They contain three broad requirements.<sup>33</sup>

Each plan seeking 404c status must provide:

*A broad range of investment alternatives* - a 404c plan must have at least three different investment alternatives which permit diversification of accounts to minimize the risk of large losses and afford participants a reasonable opportunity to materially affect the potential return and degree of risk in their portfolios;

*Appropriate frequency of investment instructions* - participants must be able to change their investment choices frequently enough to be appropriate for the volatility of each investment alternative and no less than once every three months, and

*Sufficient investment information* - a 404c plan must provide participants with sufficient information to make informed investment decisions, including an explanation that plan fiduciaries are not responsible for participants' investment losses

in a 404c plan and information about the objectives and risk/return characteristics of each alternative, procedures for choosing and changing investment choices, and descriptions of transaction fees or expenses charged to participants' accounts.

If a plan complies perfectly with the 404c regulations, then plan fiduciaries have effectively relieved themselves of liability for participants' choices among investment options offered by the plan. But the regulations do not relieve plan fiduciaries of all their liability. The general ERISA fiduciary requirements of prudent behavior and the exclusive benefit rule continue to apply. In addition, the Department of Labor has warned that

the act of limiting or designating investment options which are intended to constitute all or part of the investment universe of an ERISA 404(c) plan is a fiduciary function ... the plan fiduciary has a fiduciary obligation to prudently select such vehicles as well as a residual fiduciary obligation 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.<sup>34</sup>

Although willing to advise plan sponsors on appropriate funds, few investment professionals will assume the responsibility and the associated liability for selecting a plan's 404c investment options. Those that do charge a premium for their services. Even so, the responsible plan fiduciary - generally, the plan sponsor - retains at least residual liability for the investment professionals they hire. So, inevitably, it is the plan sponsor who bears ultimate responsibility for the selection of investment options in a 404c plan.

**V. Their Predictable Consequences.** The issuance of the 404c regulations sparked a rush among plan sponsors to add self-directed investment options to their defined contribution plans. As Table 1 below indicates, by 1997, almost one-half of all profit-sharing plans and almost one-third of all money purchase plans - the most common defined contribution plans among corporate employers - described themselves as participant-directed plans.<sup>35</sup> Moreover, 404c plans account for 65% of the

assets of profit-sharing plans and almost 70% of all active participants. Among money purchase plans, the comparable figures are about 40% and 30%, respectively.<sup>36</sup>

<b>Table 1. Prevalence of ERISA Self-Directed Plans in 1997</b>			
<b>category</b>	<b>profit-sharing</b>	<b>money purchase</b>	<b>total</b>
<b>total number of plans</b>	520,446	102,493	622,939
<b>total 404c plans (% of total plans)</b>	257,289 (49%)	31,749 (31%)	289,038 (46%)
<b>total assets</b>	\$1,453,685,116,159	\$143,841,976,877	\$1,597,527,093,036
<b>total 404c assets (% of total assets)</b>	\$949,877,373,157 (65%)	\$58,414,156,708 (41%)	\$1,008,291,529,865 (63%)
<b>total active participants</b>	47,849,596	4,516,169	52,365,765
<b>total 404c participants (% of total participants)</b>	32,583,357 (68%)	1,417,763 (32%)	34,001,120 (65%)

There is no single explanation for this change. Even though there was no obvious threat of large-scale litigation over plan investments, plan sponsors felt they had nothing to lose - and perhaps a lot to gain - by conforming their plans to the 404c regulations. So many did so. In part, it was prompted by the increased prevalence of 401k and 401k-type plans. Participants in these plans typically feel strongly that their contributions are their funds, and they should be permitted to decide how they will be invested.

But the marketing efforts of the mutual fund industry - for whom the 404c regulations were almost tailor-made - were also a major contributor. The industry already had the product - a vast array of investment funds - necessary to satisfy the broad range of alternatives requirement of the 404c regulations. It already had the technology - daily transfers, voice (and now internet) initiated transactions - necessary to satisfy the frequency of investment instructions requirement. And it

already had the disclosure material - prospectuses prepared under S.E.C. requirements - necessary to satisfy the sufficient investment information requirement. It also had a bundled product of investment options, record keeping services and prototype plans to offer plan sponsors just as they were beginning to out-source their benefit plans. Most important, it held a very important trump card over its competitors: banks offering common and collective trust funds and insurance companies offering separate accounts as investment options. The mutual fund industry alone had been granted a total exemption from the fiduciary liability provisions of ERISA when it was enacted.<sup>26</sup> It could therefore heavily promote the 404c regulations to expand its defined contribution business with no downside risk. It took several years for banks and insurance companies to convert their traditional investment products into the technical legal form of a mutual fund and become competitive.

The mutual fund industry utilized the 404c regulations as a marketing tool to employers, and they responded. Since the 404c regulations were issued, the mutual fund industry has rapidly increased its market share and amount of assets under management. In 1992, for example, mutual funds held a 45% share in the defined contribution plan market with about \$82 billion in assets; in 1999, the comparable figures were a 65% share and \$777 billion in assets. In 1992, they held a 15% share of the 401k asset market with about \$550 billion in assets; by 1999, that market had grown to \$1.7 trillion in assets and the share held by mutual funds had tripled to 45%.<sup>36</sup>

The irony is that as employers turned to the 404c regulations as insurance against litigation over plan investment performance - litigation that was not even on the horizon - they may have inadvertently created the litigation and the liability they sought to avoid. The 404c regulations provide more than the substance for the fiduciary litigation that is now beginning. They also provide

the means. Class-action lawyers have recently discovered the 404c regulations as a potential source of lucrative litigation. Plans attempting to comply with those regulations exhibit all the necessary ingredients for a class action law suit: large numbers of similarly-situated plaintiffs, identical causes of action; huge amounts of potential damages and possible generous awards of attorneys' fees.<sup>37</sup>

Consider the following new cases:

*Sue B. Franklin, et al. First Union Corporation, et al.*:<sup>38</sup> This case is a \$150 million class action law suit filed on behalf of about 5,000 former employees of Signet Banking Corporation ("Signet") which was purchased by First Union Corporation ("First Union"). The suit alleges that First Union and other fiduciaries committed various breaches under ERISA after First Union merged the Signet 401k plan into a First Union plan which limited investment options to its own family of funds. A ruling is expected soon on a motion for summary judgment on the heart of the 404c-related charges - that by liquidating all non-proprietary investment options in favor of its own funds First Union breached its fiduciary duties and acted in its own self-interest to increase its fee income, rather than for the exclusive benefit of plan participants.<sup>39</sup> First Union is also charged with having acted imprudently by failing to investigate whether non-proprietary funds could provide participants with superior-performing, less expensive investment options than its own funds.<sup>40</sup> A second 404c-related charge alleges that First Union failed to provide participants with adequate notice of the change in options and their right to opt-out. The court has so far denied both parties' motions for summary judgment on this count but, as a preliminary matter, has held that ERISA § 404(c) requires fiduciaries to disclose changes in funds so that participants can make informed investment decisions.

*Sue B. Franklin, et al. v. First Union Corporation, et al.*:<sup>41</sup> This recent law suit is another class action suit against First Union on behalf of some 100,000 of its current and former employees. It seeks over \$300 million in damages, equitable relief and permanent removal of current fiduciaries from the First Union 401k plan in favor of an independent, disinterested fiduciary. It alleges violations of ERISA's fiduciary provisions as well as other federal statutes, the federal Racketeer Influenced and Corrupt Organizations Act ("RICO") and the antitrust provisions of the Bank Holding Company Act.<sup>42</sup> Its ERISA claims again center on breaches of fiduciary duty under ERISA's prudence and exclusive benefit standards as well as violations of the 404c regulations. The law suit alleges that First Union used the assets of its 401k plan as "seed money" to launch its own 401k investment and recordkeeping business. Then, in order to promote its own corporate interests by increasing its fee income, First Union restricted investments in its 401k plan to its own family of funds and appointed First Union-controlled entities as the plan's record-keeper and trustee. Finally, the suit alleges that First Union charged participants excessive and illegal fees and expenses while third-party clients received fee discounts, offsets, and waivers. In addition, First Union routinely hid and in some cases misrepresented the fees participants were being charged.

*Gottlieb, et al. v. SBC Communications, Inc., et al.*:<sup>43</sup> This law suit is a class action suit under ERISA on behalf of some 40,000 former employees of Pacific Telesis Group ("PacTel") which was acquired by SBC Communications, Inc. ("SBC"). The suit alleges that, after two PacTel 401k plans were merged into the SBC 401k plan, SBC forced former PacTel participants to sell their plan holdings in stock of AirTouch Communications, Inc. ("Airtouch"). PacTel participants had acquired this stock through PacTel plans' company stock fund when Airtouch, a direct competitor of SBC,

was spun-off as a separate company. SBC then caused the Airtouch proceeds to be transferred to the company stock fund in the SBC plan and invested in SBC stock. After the liquidation, AirTouch was acquired by another company and its stock tripled in value. SBC is also alleged to have provided participants with misleading and incomplete information about their rights to receive a distribution of, rather than liquidate, their AirTouch stock. The plaintiffs seek damages of some \$1.1 billion in lost investment return and other equitable relief.

*Mehling, et al. v. New York Life Insurance Company, et al.*<sup>44</sup> This suit is also a class action law suit for damages and equitable relief under RICO, ERISA and the New Jersey Conscientious Employee Protection Act. Its ERISA claims allege that New York Life Insurance Company (NYL) improperly used the assets of its own defined benefit and defined contribution plans as seed money for a new line of mutual funds. These mutual funds were intended to launch NYL into a new lucrative area -the bundled 401k plan business. NYL is then alleged to have used the funds, characterized as expensive and poorly-performing, in its own plans (both defined benefit and defined contribution) to collect excessive fee income from plan participants, a potential act of self-dealing and violation of ERISA's exclusive benefit rule. The law suit asks for treble damages, estimated to be in the neighborhood of hundreds of millions of dollars, on behalf of a class of plaintiffs believed to number in the tens of thousands.

The outcome of any of these cases is unpredictable. They are still in their initial stages with discovery just beginning. So it is not immediately apparent how good a case any of these plaintiffs have. But mounting a 404c defense can be very difficult. The Department of Labor takes the position that compliance with the regulations is determined on a case-by-case basis and the burden

is on the party asserting a defense under ERISA § 404(c) to prove that the conditions of the statute and the regulations have been met.<sup>45</sup> At the same time, it is not clear how the law under ERISA § 404(c) will develop. There has been very little litigation related to ERISA § 404(c) and even less related to the new regulations. In the case of first impression, *In re Unisys Savings Plan Litigation*, the appellate court gave an expansive reading to ERISA § 404(c). It held that plan fiduciaries could not be held liable for fiduciary violations, even of ERISA's prudence requirement, if they could establish that participants' losses were caused by their own exercise of investment control under ERISA § 404(c).<sup>46</sup> But this case was based on events that arose before the 404c regulations were effective. Its holding, in addition, seems contrary to position taken by the Department of Labor in the regulations that plan fiduciaries remain liable for the selection and monitoring of the different funds or investment vehicles made available under a 404c plan. Courts typically defer to a government agency's interpretation of statutes over which it has authority. So future judicial decisions may rely heavily on the Department of Labor's regulations when interpreting ERISA § 404(c). In addition, the *Unisys* holding may not be followed by other courts.

Moreover, these law suits have been well-crafted by plaintiffs' attorneys. The defendants (major corporations, insurance companies and banks) have deep pockets. Some are in the 401k business themselves and are uniquely vulnerable to the negative publicity an ERISA breach of fiduciary duty suit brings. In addition, plaintiffs' attorneys have leveraged their ERISA claims wherever possible with additional claims under other state and federal laws. These non-ERISA claims are particularly valuable because they offer the potential of triple damages and a jury trial which ERISA by itself cannot.<sup>50</sup> This is a potent combination of forces which other litigators will emulate.

At the very least, these cases will likely result in the creation of something that ERISA has always lacked: a plaintiffs' bar.

As - not if - that plaintiffs' bar grows, litigation will not be limited to the major corporations. Every plan sponsor will be vulnerable to 404c litigation for a number of reasons. First, many plan sponsors don't fully understand the 404c regulations. They believe they have found a liability-free form of plan sponsorship. They don't understand that even if their plan satisfies the regulatory requirements they have transferred only a portion of their fiduciary responsibility. They don't realize they have a continuing responsibility to monitor the investment options of their plans or know how to set up an appropriate process to do so. They also don't understand that if they fail to comply with the regulations, even inadvertently, they have magnified their fiduciary exposure. They will arguably become co-fiduciaries with participants and the potential deep pocket when their investment decisions turn out poorly.

Second, although investment performance will be the first line of attack, that is not the only weapon in plaintiffs' arsenal. An equally powerful allegation - and one perhaps more difficult to defend - is that participants were not provided adequate information for making an informed investment decision. Therefore, plan fiduciaries, not participants, should be liable for any losses in participants' accounts. Many employers will be vulnerable to such a claim. Many are less than careful about the quality and the timing of the disclosure information they provide to participants, relying on the routine materials available from their investment providers. Sometimes plan sponsors even neglect to notify participants that the plan is intended to be a 404c plan - a cardinal requirement of the regulations. Participants will find it easy to assert that disclosure materials were inadequate and

did not meet regulatory standards. Consequently, they did not make an informed investment decision and should be made whole for the losses in their accounts. Such a claim is likely to appeal to any jury composed of even ordinary investors.

The most predictable consequence of the 404c regulations is litigation. Sooner or later some plaintiffs will win a big case and some plan sponsor will pay large damages to make participants and the plan whole. When that happens, plan sponsors will begin to recognize the extent of their liability under ERISA § 404(c). They will rethink their options and find they have very few. The trend to self-directed plans seems irreversible. Taking the right to direct the investment of their accounts away from participants won't be practicable- and doing so would just give plan sponsors more, not less, fiduciary exposure. Neither will it be possible to find another party to assume that liability. The plan sponsor will inevitably be the fiduciary of last resort. At that point, many will question whether they really want and can afford to be the potential involuntary insurer of their employees' investment choices. And many plan sponsors - particularly small employers - will probably decide they do not.

**VI. An Alternative Construction for ERISA.** Before that unhappy day arrives, it is useful to consider whether it might be averted. This section presents a new model for ERISA that simplifies its regulatory framework to fit today's defined contribution world. In doing so, it recognizes the growing importance of third parties - and the reduced role played by employers - in critical plan functions such as administration and investment and then reallocates legal responsibilities to reflect that reality. The model is based on the following observations.

**1. ERISA § 404(c) is the exception, not the rule.** It is important to recognize that ERISA's fiduciary scheme is a relatively recent innovation in the private pension system. Indeed, the

approach taken by the 404c regulations to impose liability on fiduciaries who choose plan investment options is consistent with ERISA but is not the standard elsewhere. Many other types of plans have always featured investment self-direction by participants but do not impose fiduciary responsibility on plan sponsors. For example, millions of employees of Internal Revenue Code § 501(c)(3) entities - hospitals, charities, private schools and universities - as well as public schools contribute to tax-sheltered annuities under Code § 403(b). These accounts are not subject to ERISA provided they contain no employer contributions or other substantial employer involvement.<sup>51</sup> These accounts have historically been self-directed, and employers play almost no role, in line with ERISA regulations, in limiting or otherwise selecting the investment providers available to their employees. The same is true for millions of government employees who participate in Internal Revenue Code § 457 plans which are not subject to ERISA's fiduciary scheme. These plans operate much like 401k plans and have also historically been self-directed.<sup>52</sup> Finally, millions of Americans have individual retirement accounts ("IRAs") under Internal Revenue Code § 408 that are exempt from ERISA and provide an almost limitless choice of investments.<sup>53</sup>

**2. ERISA's fiduciary scheme suits defined benefit - but not defined contribution - plans.** Under a defined benefit plan, the plan sponsor makes a promise today to pay benefits many years in the future. If the plan has insufficient assets to pay the promised benefits as they mature, the obligation to make good any shortfall falls on the plan sponsor and ultimately, after ERISA, on the government-run insurance program.<sup>54</sup> It was logical for ERISA's drafters to make the defined benefit plan sponsor the ultimate fiduciary in order to compel it to keep the plan solvent. In order to protect taxpayer resources, it was also rational to impose personal liability on plan officials and investment

professionals and hold them personally accountable for any misuse or mismanagement of plan assets. The fiduciary structure created by ERISA has served defined benefit plan participants well.

But defined contribution plans are fundamentally different. The plan sponsor promises only to make a contribution from time to time. There is still a risk that employees will reach retirement and find no pension but not because the employer has defaulted on a promise to contribute. The employer fulfills its contractual promise every year. If it doesn't, both Code and ERISA enforcement systems soon compel it to do so. The pension risk in defined contribution plans is that not enough dollars will be saved or the dollars saved will be poorly invested. In today's defined contribution world, that risk has largely been transferred from the employer to the employee.

**3. Defined contribution plans today are just another financial services industry product, not “employer plans.” But employers remain responsible under ERISA.** Many employers today do not operate or manage their own defined contribution plans. The typical 404c plan is actually a bundle of services provided by an investment provider or through a strategic alliance of consulting firms and mutual fund families. The employer's unique contribution is to decide whether to make a contribution in a given year. The employer is then just the conduit of contributions (its own and participants) to the investment provider. In addition to its investment services, the provider performs most other plan functions: accounting, record keeping, discrimination testing, compliance, tax reporting, and disclosure. It also provides a “check-the-box” prototype plan. Participants communicate directly with the provider when they wish to choose or change their investment options.

In these arrangements, the employer remains liable even though third-parties actually perform almost all necessary functions. The standard legal documents governing these arrangements usually contain language to the effect that the service providers are acting under the instructions of, that is they are “directed” by, plan officials. As a result, the service providers take the position they are not ERISA fiduciaries because they perform no discretionary functions. In addition, the service providers are subject to the lowest standard of care in the performance of their duties. The documents usually provide that the service providers will not be liable for their actions unless they have been “grossly” negligent. Many plan sponsors routinely sign such documents without benefit of legal counsel. They are usually unaware that, not only have they not reduced their own fiduciary liability, they have just assumed additional liability for the performance of others over whom they have no control. The operational significance of the employer has decreased in today’s defined contribution plan but its ERISA responsibilities have in fact grown.

**4. 404c plans will soon be just a collection of individual brokerage accounts.** Few 404c plans today restrict themselves to the minimum three investment options required by the regulations. Investment providers continue to create new mutual funds, and plan sponsors continue to expand their plan investment menus. A recent study of some 500 employers by Hewitt Associates found that they offered 11 funds in 1999 (up from 8 in 1997) on average, and 9 was the median number of funds available.<sup>55</sup> It is not uncommon for plan sponsors to make a large number of funds available, and some even offer all their investment providers’ funds. Moreover, plan sponsors are increasingly moving beyond a mutual fund menu to a self-directed brokerage option. The self-directed brokerage format allows participants to buy and sell virtually any asset - any mutual fund

or individual security - available through a stock broker. One recent study found that about 15% of 401k plans now include such an option. In addition, one leading investment provider reported that so far in 2000 about 75% of its new plans include brokerage options, and assets in such account have risen 140% in the past year to \$5 billion.<sup>56</sup>

From a legal perspective, a self-directed brokerage option presents one possible end run around the 404c fiduciary dilemma for plan sponsors. It easily satisfies the requirements for the first two 404c requirements. In addition, because the 404c plan does not designate a specific investment menu, it is held to a lesser standard when satisfying the third - the sufficient information standard. A self-directed option must satisfy a number of other technical requirements to completely immunize a plan sponsor from fiduciary law suits. But while a concern to lawyers trying to protect their clients, it is, practically speaking, not an important consideration. The beauty of a self-directed brokerage account structure for plan sponsors is that it holds class action lawyers at bay. Because every participant has a unique portfolio and free choice of investments, claims for fiduciary breaches should be fewer in number, individual in nature and smaller in size.

Individual brokerage accounts have been criticized for being expensive and complicated, and many view the addition of individual securities as investment options as risky. But the types of securities they can hold is really not their true significance. Rather, it is that they are the logical next step as plan sponsors move to an open-ended investment format for their 404c plans in response to the marketing efforts of the financial services industry. Participants will soon have almost unlimited investment choices in their 404c accounts. And as the connection between the plan sponsor and the

investment options of its 404c plan grows weaker, so does the rationale for imposing fiduciary liability on the plan sponsor for the choice of those options.

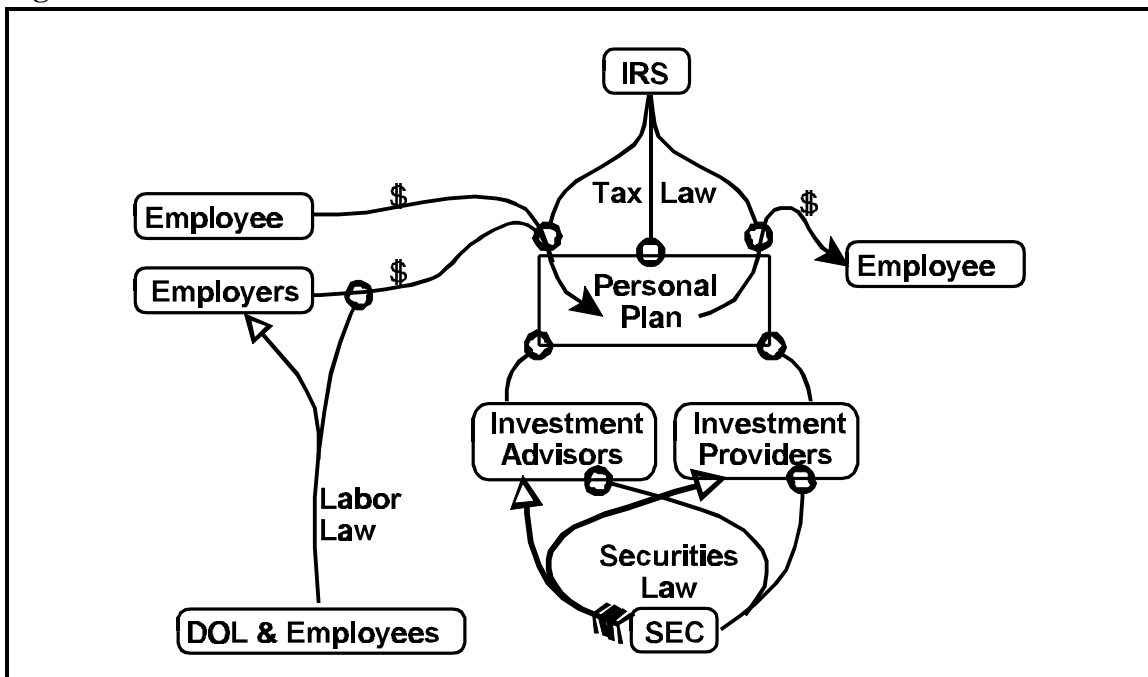
The objective of the 404c regulations - to shield participants in self-directed plans from market risk - is certainly worthy. But it has chosen the wrong instrument - the plan sponsor - for that purpose. The financial services industry - not the plan sponsor - effectively controls the defined contribution universe as it evolves with new products and technology. And it - not the plan sponsor - ultimately produces the investment returns for participants' accounts. Plan sponsors may reasonably ask: if the investment professionals actually making the investment decisions for trillions of participant dollars in mutual funds chosen by participants are not ERISA fiduciaries, why am I?

That's a good question. And the issues it raises go beyond the 404c regulations to the fundamental structure of ERISA itself for today's defined contribution plans. Certainly, if we were sitting down now to design an ERISA for today's defined contribution world, it wouldn't look much like the ERISA that was set in place twenty-five years ago. We would recognize that the employer plays very different roles today. For a variety of reasons, employers seem to be crucial to "saving" by employees. Many of the routine services they provide encourage saving by making it easy and convenient: payroll deductions, simplified enrollment, periodic reports, and investment education. They may provide financial incentives to save through matching contributions. They also serve as an important intermediary between their employees and the financial services industry and thus simplify the investment process for their employees. The roles the employer plays are important, and often critical, determinants of employee saving. But in those roles, they act more as a facilitator than a fiduciary.

In the future, it is not so much that employers' roles will diminish but only that they will be concentrated on what they do best: bargain on behalf of the employee (in larger firms) for better service providers, create viable pension and insurance options (in larger firms), and provide direct deposit, payroll deduction and tax services for employer and employee contributions to pensions. They will engage in low-cost paternalistic efforts to encourage their employees to have enough savings so they can retire when their skills drop sufficiently with age. And, whether or not there are 404c regulations to compel them, they may wish to perform some sort of oversight function over where and how their employees save. While plan sponsors' responsibilities will never be entirely eliminated, they will continue to terminate or reduce their involvement in areas where they have no special expertise - such as plan operations and investment management - and where they see other firms being sued for activities not related to their core business.

It therefore seems reasonable to ask how ERISA could be simplified to fit today's realities. What might ERISA look like if we took it apart and rearranged its pieces to enable the employer to be a facilitator rather than a fiduciary? It might well look like this.<sup>57</sup>

**Figure 3. The Personal Plan**



This model has the following central features:

*First*, like an IRA and most 403(b) tax-deferred annuities, there is no “employer plan.” The employer plan has been disaggregated into individual accounts, here, for lack of a better term, called “personal plans.” A personal plan is the equivalent of each participant’s individual account in today’s defined contribution plan. It is the recipient of all contributions made to that account and is composed of all the investment options in which those contributions have been invested. The purpose of the personal plan is to relieve employers from operational and investment management responsibility for their employees’ retirement assets, assets which are today effectively held and managed by third party administrators and investment professionals.

The personal plans could be established by individuals, independent of their employment status, at participating financial institutions. Or employers might serve as an intermediary and arrange for

financial institutions to offer such plans to their employees, much like the arrangement today in most of the 403(b) world. Employers might also choose a single financial institution for an initial deposit of their and their employees' contributions with employees having the right, as is true today under a SEP, to then transfer those contributions to the provider of their choice.<sup>58</sup> Any number of different arrangements regarding investment options and investment providers - designed to suit both employers who wish to assist their employees in their investment choices and those who do not - would be feasible.

*Second*, from a legal perspective, the significance of the personal plan is that it - rather than an umbrella employer plan - is the legal holder of each employee's retirement savings. This also relieves the employer from responsibility for employees' retirement savings that are actually held by third parties. The plan document which today governs an employer plan would be replaced by an equivalent legal document governing the personal plan. That document would spell out the legal relationship - the rights, duties, obligations and privileges - of the employee and the financial provider holding those funds, as is true of an IRA today. In order to assure that personal plans were held by responsible parties, it would be preferable to permit only regulated financial institutions to offer personal plans.<sup>59</sup> Tax law would largely control those legal rules and set guidelines for which financial institutions could offer personal plans, again as is true with IRAs today.

The trust document which today governs those holding the assets of an employer plan would also be replaced. It is likely that the personal plan would assume the legal form of a custodial account rather than a trust, as is true today for most IRAs and 457 plans for government employees, in order to make personal plans attractive to the financial services industry. This means that the personal plan

would be bound by contract law without the overlay of trust and fiduciary law now found under ERISA. Breaches by custodians could be subject to the usual contractual remedies which might include punitive damages which are not available today.

*Third*, because the personal plan relieves the employer from much of the day-to-day responsibilities involved in operating and managing an employer plan, its core administrative function is reduced to serving as a conduit of contributions to the personal plans of its employees. It deducts employee contributions from their pay, adds its own contributions, if any, and wires those funds directly to the appropriate provider for transfer to each employee's plan. In many ways, this would be no more complicated than the direct deposit of payroll checks or the direct transfer of 401k contributions to the investment provider that most employers now do routinely.

But the employer will continue to play its unique and very valuable role as a contributor to its employees' personal plans. How much it contributes and to whom would be governed by tax law, and many of today's rules could continue to apply. Tax law would still attempt to encourage employer participation by providing special tax benefits for contributions while discouraging contributions which disproportionately favor highly-compensated employees. So employer contributions would still be subject to rules on participation, coverage, and non-discrimination. There would still be per employee limits on the annual contributions any personal plan could receive and any employer could make. And, there might even be a mandated employer contribution. Today's automatic but "opt-outable" 401k contribution certainly looks and acts a lot like a mandatory employee contribution.<sup>60</sup> Perhaps someday there might be a parallel provision for employers, either as part of the non-discrimination rules or in place of them.

*Fourth*, the employer's contribution would be governed by labor law as well as tax law. Any contribution promised by a particular employer would become part of each employee's contract of employment, as a legal matter, and enforceable by employees and the Department of Labor. Any failure on the part of the employer to make a promised contribution would be subject to contractual damages and equitable relief as well as enforcement penalties imposed by the Department of Labor.

*Fifth*, tax law would continue to have rules for how much employees could contribute to their plans every year. It would also determine when employees could or must take distributions, just as it does today. For example, a personal plan could offer loans and hardship distributions much like an employer plan does today. Tax law would also include rules that the personal plan would have to satisfy to remain tax-qualified and impose penalties for violations of those rules, much like it does today for pension plans and IRAs.

*Sixth*, the federal securities laws today are the primary regulators of the financial services industry as well as its investment products, investment providers and investment advisers. Those laws would safeguard the retirement assets held in personal plans through their regulation of the available investment options as well as the behavior of investment professionals who provide custodial, management and advisory services. It is important to recognize, however, that retirement plan investors are generally treated no differently from any other investors under the securities laws today. They have access to the same types of investments. They receive no additional protections. An argument can be made that retirement assets are sufficiently special so as to merit some extra safeguards. This model does not require or advocate any such rules but could easily accommodate them through amendments to securities law.

Thus, the model recognizes that each participant's account in today's employer plan is really a separate plan with a unique contribution pattern and investment portfolio. It strips away the superstructure of the increasingly obsolete employer plan. What's left is a personal defined contribution plan for individuals. Employees will have a centralized account for all their retirement funds - no matter how many employers they had or who they were. They largely control how those funds are invested and where they are held - no problems with portability and no need for rollovers. Employers will be free to focus on the function we want most to encourage: making contributions on behalf of employees. They need only send their contributions to their employees' personal plans - no plan management responsibilities, liabilities or costs.

But employers would still play a critical role, if they chose to do so, as facilitators of their employees' personal plans. Many would choose to retain oversight and act as an intermediary for their employees' personal plans in a variety of ways from encouraging saving to providing investment education and retirement planning services. Moreover, many would wish to designate a preferred provider for their employees or to review the quality and limit the number of providers they make available to employees. The financial services industry would likely to respond to personal plans by creating new types of investments and innovating new services, products and providers. A personal plan, for example, could be run as easily by a TIAA/CREF or a Federal Thrift Board as by a brokerage house or mutual fund family that offers access to almost any mutual fund or individual security. And employers would play an important role in helping their employees make a successful transition through those new products and services to appropriate personal plans.

The personal plan model is not particularly revolutionary. It borrows features and systems from other sections of the private pension system and applies them to ERISA plans. Its primary contribution is to recognize that the regulatory structure that ERISA created twenty-five years ago for defined contribution plans is no longer appropriate. In particular, the burden of liability placed on the employer - exemplified by the 404c regulations - is no longer justifiable. The solution it proposes is just one that might be adopted. But reconstructing ERISA to fit today's defined contribution world - and today's employer - is important. Beyond the contributions they make, employers are crucial to employee savings. Facilitating the continued involvement of employers in the private pension system is an objective worthy of attention now, before the predictable consequences of the 404c regulations come to pass.

## End Notes

1. "ERISA" is the acronym for the Employee Retirement Income Security Act of 1974, the primary federal law regulating the private pension system. The term "private pension system" as used in this paper includes all arrangements to produce retirement income authorized by the Internal Revenue Code such as qualified plans, tax-sheltered annuities, plans based on individual retirement accounts, individual retirement accounts and other deferred compensation arrangements. It does not include equity-based plans or arrangements such as stock option or stock purchase plans. ERISA applies to only a subset of private pension system plans. Plans sponsored by a governmental entity or a church, plans without employer contributions, and certain deferred compensation arrangements are, in general, are exempted from ERISA. ERISA actually incorporates both labor and tax (duplicated from the Code) rules. This paper will focus on the labor provisions of ERISA.
2. United States General Accounting Office, "Pension Plans: Characteristics of Persons in the Labor Force Without Pension Coverage," GAO/HEHS-00-131, August 2000.
3. See Pamela Perun and C. Eugene Steuerle, "ERISA at 50", Occasional Paper No. 4, The Retirement Project, The Urban Institute, March 2000.
4. If a pension plan qualifies under Internal Revenue Code rules, it receives special tax treatment. For example, contributions to the plan are made on a pre-tax basis. In addition, neither those contributions nor their earnings are taxed while they accumulate in the plan. Participants in the plan are only taxed when they receive distributions of their benefits from the plan, typically at termination of employment or retirement.
5. See, for example, Internal Revenue Code § 402 as in effect prior to the enactment of ERISA.
6. Internal Revenue Code § 401(a)(2). In 1969, the Treasury Department issued Revenue Ruling 69-494, 1969-2 Cumulative Bulletin 88, which held that an investment would satisfy the Code's "exclusive benefit" rule provided: (1) its cost didn't exceed fair market value at time of purchase; (2) it provided a fair return commensurate with the prevailing rate; (3) the plan otherwise maintains sufficient liquidity to permit distributions; and (4) the safeguards and diversity a prudent investor would adhere to are present.
7. Treasury Regulation § 1.401-1(b)(5)(i).
8. Under Internal Revenue Code § 503(b), transactions involving (1) lending plan assets without adequate security and a reasonable interest rate; (2) paying excessive compensation; (3) purchasing securities for more than adequate consideration as well as selling them for less than adequate consideration; and (4) diverting plan assets to the plan sponsor or similar parties were forbidden. Similar but more elaborate provisions applicable to most qualified plans are now found in Internal Revenue Code § 4975(c). In addition, Treasury Regulation § 1.401-1(b)(5)(ii)

required, for example, that any investment of trust assets in employer securities or loans to an employer be reported to the IRS for a determination that the transaction did not violate the exclusive benefit rule.

9. Internal Revenue Code § 402(b).

10. Prior to ERISA, participants had no private right of action to contest a plan disqualification and, even today, have only such rights as are available through ERISA. Internal Revenue Code § 7476 permits a plan participant, in certain cases, to ask the Tax Court to intervene when the continuing qualification of a plan has become the subject of an actual controversy with the Internal Revenue Service. As might be expected, few participants avail themselves of this right.

11. ERISA §§ 101 and 501.

12. ERISA § 402.

13. *Ibid.*

14. ERISA § 3(21).

15. ERISA § 404(a)(1)(A).

16. ERISA § 409.

17. ERISA § 405.

18. ERISA § 502.

19. *Ibid.*

20. ERISA § 404(a)(1)(B) requires a fiduciary to act “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man, acting in a like capacity and familiar with such matters would use in the conduct of a enterprise of a like character and with like aims.”

21. The regulations under ERISA § 404(a) require a fiduciary to determine that a particular investment decision, as part of the portfolio, is “reasonably designed ... to further the purposes of the plan by taking into consideration the risk of loss and the opportunity for gain associated with the investment” choice. A fiduciary, in making an investment decision, must consider the following factors: (1) the composition of the portfolio with regard to diversification; (2) the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and (3) the projected return of the portfolio relative to the funding objectives of the plan. *See* DOL Regulation § 2550.404a-1(b)(2).

22. *Donovan v. Bierwirth*, 680 F.2d 263 (2d Cir.), cert. denied, 459 U.S. 1069 (1982).
23. ERISA §§ 404(a)(1)(C) and 406.
24. ERISA § 403(a)(1). Trustees, however, may only follow such directions if they are “proper,” made in accordance with the terms of the plan and not contrary to ERISA. This requirement imposes a duty on trustees to perform at least some minimal form of review on the merits of the directions they receive if they wish to avoid the fiduciary label.
25. ERISA §§ 402(c)(3) and 403(a)(2). ERISA § 3(38) establishes qualifications for those who wish to serve as investment managers of ERISA assets. While trustees may only follow the “proper” instructions of a named fiduciary, no such requirement applies to instructions from an investment manager. ERISA § 405(d)(1) provides that a trustee is not liable for the acts or omissions of an appointed investment manager nor under an obligation to invest or manage assets under the authority of an investment manager.
26. ERISA § 410 permits fiduciaries to obtain insurance coverage against a breach of fiduciary duty claim if the policy permits recourse by the insurer against the fiduciary in case of a fiduciary breach. To protect against the financial exposure involved in acting as a fiduciary, fiduciaries usually seek indemnifications which leave them fully responsible and liable but permit another party to satisfy any liability incurred. Indemnification is not void under ERISA. ERISA § 410 also provides that “any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability [under ERISA] ... shall be void as against public policy.”
27. ERISA §§ 406 and 408.
28. ERISA § 502(a)(1).
29. ERISA § 514(a) provides that the provisions of ERISA “shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan,” except those state laws that regulate insurance, banking or securities.
30. The Department of Labor recently reported that, in 1996, the number of defined benefit plans had decreased to some 63,000 while the number of defined contribution plans increased to some 630,000. See U.S. Department of Labor, *Private Pension Plan Bulletin*, Abstract of 1996, Form 5500 Annual Reports, Number 9, Winter 1999-2000, p.2.
31. U.S. Department of Labor, *op. cit.*, p.3.
32. Under Internal Revenue Code § 3121(v), participants pay Social Security taxes on amounts they contribute to 401k and 401k-type plans but employers do not.
33. These regulations can be found at DOL Regulation § 2550.404c-1.

34. See the Preamble to DOL Regulation § 2550.404c-1.

35. This table is based on the first author's calculations based upon data provided by Judy Diamond Associates, Washington, D.C. These data include the Form 5500 filings of about 800,000 pension benefit plans for the 1997 plan year. These data do not include figures from plans sponsored by governmental entities and have only abbreviated data on plans offered by non-profit organizations - both of which frequently offer self-directed plans under Internal Revenue Code §§ 403(b) and 457. But the fiduciary rules of ERISA usually do not apply to these plans in any event. The figures provided in Table 1 were based upon a subset of profit-sharing and money purchase plans that had not terminated during the 1997 plan year. The term "active participants" means those participants who are currently employed or are terminated but still entitled to service credit under the plan if they are rehired.

36. Of the profit-sharing plans reported in Table 1, 264,818 (47% of the total number of plans) were 401k plans. About 37% of the plans, 204,797, were both 401k and 404c plans.

26. Mutual funds are technically known as investment companies registered under Investment Company Act of 1940. They are regulated by the Securities and Exchange Commission and their exemption from ERISA's fiduciary responsibility rules was apparently based on the theory that there was no need for duplicate federal regulation through the Department of Labor. See ERISA §§ 3(21)(B) and 401(b)(1) and the plan assets regulations under DOL Regulation § 2510.3-101.

36. These figures are from The Investment Company Institute, *Fundamentals: Mutual Funds and the Retirement Market*, Vol. 9, No. 2, May 2000. The data include both non-ERISA and ERISA plans.

37. Under Federal Rule of Civil Procedure 23(a), a judge may certify a law suit as a class action, for example, when (1) the class of plaintiffs is so large that adding each plaintiff individually is impracticable; (2) there are questions of law or fact common to the class; (3) the claims of the representative plaintiffs are typical of the claims of the class; and (4) the representative plaintiffs will fairly and adequately protect the interests of the class.

38. The law suit was filed in the United States District Court, Eastern District of Virginia, Richmond Division, as Case No. 3:99CV344. Initial rulings in the case were issued on February 17, 2000 and will be reported at 84 F. Supp. 2d 720 (E.D. VA, February 17, 2000). Information about the status of the case and copies of the pleadings can be found at [www.signetsuit.com](http://www.signetsuit.com).

39. In a motion for summary judgment, the court is asked to find that both parties agree on the material facts related to a particular claim and to move directly to a ruling on the legal issues in the case.

40. The Department of Labor has issued Prohibited Transaction Class Exemption 77-3 which permits a mutual fund company to invest the assets of its own "in-house" plan in its own mutual

funds. Without this ruling, such an action would violate ERISA § 406's restriction on fiduciaries entering into certain types of transactions that are statutorily defined to be acts of self-dealing and conflicts of interest. This exemption, however, only releases a fiduciary from the prohibited transaction provisions of ERISA. It explicitly provides that fiduciaries who enter into such a transaction are not relieved of other types of liability under ERISA, including the general fiduciary responsibility provisions of ERISA § 404 which require a fiduciary to discharge his duties solely in the interest of the plan's participants and beneficiaries and in a prudent fashion. Neither does it affect the requirement of Internal Revenue Code § 401(a) that a plan must operate for the exclusive benefit of the employees of the employer maintaining the plan and their beneficiaries. See also ERISA § 3(21)(B).

41. This law suit was filed in the United States District Court, Eastern District of Virginia, Richmond Division on September 7, 1999. Information about the status of the case and copies of the pleadings can be found at [www.firstunionsuit.com](http://www.firstunionsuit.com).

42. ERISA preempts state law that "relate to" an employee benefit plan but not other federal laws. ERISA § 514(d) expressly provides that "nothing in this title shall be construed to alter, amend, modify, invalidate, impair, or supersede any law of the United States ... ."

43. This law suit was filed in the United States District Court for the Central District of California as Case No: CV-00-04139R(CWx) on April 18, 2000. Information about the status of the case and copies of the pleadings can be found at [www.airtouchsuit.com](http://www.airtouchsuit.com).

44. This law suit was filed in the in the United States District Court for the Eastern District of Pennsylvania as Civil Action No. 99-CV-5417. It was filed on June 14, 2000 as an amendment to Mr. Mehling's individual wrongful discharge action, originally filed on October 23, 1999. On July 25, 2000, four individuals were substituted for Mr. Mehling as class representatives. Information about the status of this case and copies of the pleadings can be found at [www.newyorklifesuit.com](http://www.newyorklifesuit.com).

45. See the Preamble to DOL Regulation § 2550.404c-1.

46. The *Unisys* case arose out of the purchase of guaranteed investment contracts from the Executive Life Insurance Company which subsequently failed. The appellate court decision can be found at 74 F.3d 420 (3d. Cir. 1996), and the subsequent district court decision on remand from the Third Circuit is reported at 21 EBC 2514 (E.D. PA, 1997).

50. While ERISA does not provide for treble damages or a jury trial, courts have held that ERISA does not invalidate such rights under other federal laws and have authorized, for example, jury trials in hybrid actions containing both types of claims.

51. See DOL Regulation § 2510.3-2(f).

52. In response to the bankruptcy of Orange County in California, Internal Revenue Code § 457 has recently been amended to require, beginning in 1999, government entities to hold 457 plan assets in trust subject to an exclusive benefit rule. It will be interesting to see if - and to what extent - this new requirement results in the imposition of fiduciary liability on governmental employers for the investment options available to employees participating in 457 plans.

53. IRAs are also exempt from ERISA provided they contain no employer contributions. *See* DOL Regulation § 2510.3-2(d). Internal Revenue Code § 408(m) does provide some limits on the permissible investments for IRAs by forbidding the purchase of works of art, rugs, stamps, gems, alcoholic beverages and other items deemed to be “collectibles.”

54. *See* ERISA §§ 4001 - 4402 which govern the Pension Benefit Guaranty Corporation and its program of plan termination insurance.

55. Hewitt Associates, *Survey Highlights: Trends and Experience in 401(k) Plans, 1999*, Lincolnshire, Ill.: January 2000.

56. *The New York Times*, “More 401(k)s Have Brokerage Option”, August 17, 2000.

57. *See op. cit.*, footnote 3, *supra*.

58. *See* Internal Revenue Code § 408(k)(4).

59. Almost anyone, including private individuals, can serve as a plan trustee in the private pension system, unless they have been convicted of certain serious crimes and are then barred by ERISA § 411 from acting in any capacity on behalf of a plan. Under Internal Revenue Code § 408(a)(2), IRAs may only be held by a bank or by any other entity or individual which has received specific approval from the Treasury Department to act in such a capacity.

60. “Negative” elections have become a new feature in the private pension system. Such elections permit an employer to provide in its 401k or similar plan that, unless employees affirmatively elect *not* to participate, a stipulated percentage of their pay will be withheld and contributed to the plan on their behalf.

**Appendix. Summary of Selected Rules circa 2000: Part 1**

**IRC § 401(a) Plans**

**IRC § 403 Arrangements**

	<b>Defined Benefit</b>	<b>Money Purchase</b>	<b>Profit Sharing or Stock Bonus &amp; Standard 401(k)</b>	<b>Profit Sharing or Stock Bonus &amp; SIMPLE 401(k)</b>	<b>Other Profit Sharing or Stock Bonus without 401(k)</b>	<b>Employee Stock Ownership Plan</b>	
<b>Eligible employer</b>	Any employer	Any employer except state and local governments	401(k)-eligible employer with <100 employees and no other plan	Any employer	Corporate employer	IRC § 501(c)(3) organizations and public schools	
<b>Overall limits</b>	Annual benefit limit = lesser of \$135,000 or 100% × high 3 years' pay (not governmental plans)	Per person annual limit = lesser of \$30,000 or 25% of pay <sup>1</sup>	Per person annual limit = 401(k) + match	Per person annual limit = lesser of \$30,000 or 25% of pay <sup>1</sup>	Lesser of \$30,000 or 25% of pay or exclusion allowance (20% of pay × years of service – employer contribution) <sup>1</sup>		
<b>Pay limit</b>			\$170,000				
<b>Annual funding</b>	Normal cost + past service liability amortization over 10 years or 155% of current liability	Amount required by plan formula	Match up to 3% or fixed 2% of pay contribution required		NA, usually		
<b>Employee limits</b>	NA	NA	\$10,500	\$6,000	NA	\$10,500	
<b>Employer deduction limits</b>	Based on funding requirement	Based on funding requirement	Greater of 15% of taxable pay or required contribution	15% of taxable pay	15% of taxable pay	25% leveraged/15% nonleveraged of taxable pay + dividends paid out + interest on loan	NA
<b>Exclusion from SS tax</b>	Yes, contributions and distributions	Yes, contributions and distributions	No 401(k), yes other contributions and distributions	No 401(k), yes other contributions and distributions	Yes	Yes	No deferrals, yes employer contributions and distributions
<b>10% early withdrawal tax</b>	Sometimes	Yes	Yes	Yes	Yes	Yes	Yes

		IRC § 401(a) Plans				IRC § 403 Arrangements
	Defined Benefit	Money Purchase	Profit Sharing or Stock Bonus & Standard 401(k)	Profit Sharing or Stock Bonus & SIMPLE 401(k)	Other Profit Sharing or Stock Bonus without 401(k)	Employee Stock Ownership Plan
In-service withdrawals	Not allowed		Financial hardship, <sup>2</sup> minimum 2-year holding period (employer), loans		Minimum 2-year holding period, loans	Financial hardship, <sup>2</sup> loans
Non-discrimination rules (not governmental plans)	General rule <sup>3</sup>		ADP, ACP, safe harbors and general rule <sup>4</sup>	NA	General rule <sup>3</sup>	ACP for match, availability test for deferrals and general rule <sup>4</sup>
Integrated with Social Security	May be	May be	May be (employer)	No	May be	May be
Spousal protection	Survival annuity, consent and death benefit rights			Only death benefit usually <sup>5</sup>		
Vesting	Deferred		401(k) immediate; others deferred	Immediate	Deferred	Deferrals immediate; others deferred
Special requirements	PBGC guarantee and premium of \$19 per participant	Minimum funding required in full each year		None	Forfeitures/interest raise annual limit if ≤ 1/3 contributions for HCEs. 100% employer securities allowed. Diversification optional at 55. Put option/voting rights.	Catch-up contributions permitted with 15+ years of service. May also be a DB plan.

1. The \$30,000 overall dollar limit is a cumulative limit for employers and employees across all qualified plans.

2. Financial hardship is an immediate and heavy financial need, even if foreseeable or voluntarily incurred, not satisfiable by other resources.

3. No HCE may receive a contribution or benefit of a higher percentage of pay than any NHCE.

4. Both the Actual Deferral Percentage (ADP) test for 401(k) contributions and the Average Contribution Percentage (ACP) test for matching and after-tax contributions are designed to limit contributions for HCEs (highly compensated employees) based on the average contributions for NHCEs (non-highly compensated employees).

5. The surviving spouse receives the account balance as a death benefit, usually in a lump sum.



	IRC § 408, 408A IRAs			Nonqualified Deferred Compensation Plans		
	Traditional IRA	Roth IRA	SEP-IRA	SIMPLE IRA	Eligible 457(b) plans	Executive Arrangements
Penalty tax exceptions	Medical, first home purchase and higher education expenses, health insurance payments for unemployed	First home purchase (up to \$10,000)	Same as traditional IRA	Same as traditional IRA	NA	None (unless annuity purchased)
Withdrawals	Yes	5-year waiting period	Yes	Yes	Unforeseeable emergency only while employed	Yes
Loans available		No			Unclear	Yes
Non-discrimination rules	None	None	Uniform percent of pay contribution	Required match or contribution	Can favor HCEs	None
Pay limit	See above		\$170,000	\$170,000 for 2% contribution	NA	
Integrated with Social Security	NA		May be	No	NA	
Spousal protection				None		
Vesting		Immediate			Immediate usually	Immediate for employee; deferred for employer
Special restrictions and benefits	None	After-tax contributions only	Employer does not have to contribute every year	Employees generally responsible for investments	\$15,000 catch-up limit for 3 years before retirement. Unfunded plan but trust requirement for public-sector plans. May also be a DB plan.	Taxed when paid or made available (or when vested for tax-exempts). May be DC or DB.

*Note:* All dollar values are indexed, and the given figures are as of 2000.

*Sources:* Harry Conaway, William M. Mercer and C. Eugene Steuerle, Andrea Barnett and Pamela Perun, the Urban Institute.