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Three and Possibly Four Lessons about ERISA That We Should, but Probably Will Not Learn from Enron

Norman Stein

THREE AND POSSIBLY FOUR LESSONS ABOUT ERISA THAT WE SHOULD, BUT PROBABLY WILL NOT, LEARN FROM ENRON

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In 1974, when President Gerald Ford signed the Employment Retirement Income Security Act of 1974 (ERISA) into law in a Rose Garden ceremony on Labor Day, he predicted that because of the new law “the men and women of our labor force will have much more clearly defined rights to pension funds and greater assurances that retirement dollars will be there when they are needed.”¹ In many ways President Ford was prescient: many of ERISA’s reforms have improved the retirement security of American workers, particularly in the areas of vesting,² plan funding,³ and insurance protection for defined benefit plans.⁴ In other areas, ERISA has not worked as well, at least from the perspective of the men and women of whom President Ford spoke at the Rose Garden ceremony.⁵ Enron and similar corporate failures are only the latest illustration of some of the statute’s shortcomings.

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¹ President Gerald Ford, Address at the White House Rose Garden (Sept. 2, 1974), <http://www.pbgc.gov/about/hptext.htm>. (last visited Nov. 18, 2002).

² See I.R.C. § 411 (2000) (establishing minimum vesting standards); Employment Retirement Income Security Act (ERISA) of 1974 § 4022, 29 U.S.C. §§ 203(a) et seq., 29 U.S.C. §§ 1053 et seq. (2000); see also Daniel Fischel & John H. Langbein, *ERISA’S Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105, 1105 (1988).

³ See I.R.C. § 412 (establishing minimum funding standards).

⁴ See 29 U.S.C. § 1322.

⁵ For articles critical of ERISA, see generally Leon E. Irish & Harrison J. Cohen, *ERISA Preemption: Judicial Flexibility and Statutory Rigidity*, 19 U. MICH. J.L. REFORM 109 (1985); John H. Langbein, *The Supreme Court Flunks Trusts*, 1990 SUP. CT. REV. 207 (1991); Dana M. Muir, *ERISA Remedies: Chimera or Congressional Compromise?*, 81 IOWA L. REV. 1 (1995); Norman Stein, *ERISA and the Limits of Equity*, 56 LAW & CONTEMP. PROBS. 71 (1993); Norman P. Stein, *Reversions from Pension Plans: History, Policies, and Prospects*, 44 TAX L. REV. 259 (1989).

This Article focuses on three particular shortcomings of the statute: ERISA sections 404(a)(2)⁶ and 407(b),⁷ which for defined contribution plans relax regulatory requirements restricting investment in stock of the sponsoring employer; ERISA section 404(c),⁸ which provides incentives for firms sponsoring defined contribution plans to shift responsibility for portfolio allocation to plan participants; and ERISA section 408(c),⁹ which expressly permits directors and employees of a plan's sponsor to serve as plan fiduciaries and implicitly permits them to make critical judgments on issues pitting the interest of the plan's sponsor (or the managing employees of the sponsor) against those of plan participants. The Article also takes a brief look at another problem with the statute (at least as it has been interpreted by the Supreme Court), which may yet become part of the Enron story: ERISA sections 502(a)(2)¹⁰ and (a)(3),¹¹ which in many instances bar participants from securing make-whole remedies against individuals who participate in fiduciary breaches that harm them individually rather than harm the plan as a whole.¹²

The first part of the Article describes the story of the destruction of the retirement income security for most of Enron's employees. The final four parts of this Article consider each of the aforementioned statutory shortcomings related to that story.

I. THE ENRON RETIREMENT INCOME SECURITY STORY

Enron may be a complex story in many ways, but its basic plot line and theme for worker retirement security is straightforward. Enron sponsored a section 401(k) plan ("the Plan"), under which employees could elect to defer a portion of their salaries.¹³ The employees were given a menu of nineteen investment choices,¹⁴ one of which was Enron common stock.¹⁵

⁶ 29 U.S.C. § 1104(a)(2).

⁷ *Id.* § 1107(b).

⁸ *Id.* § 1104(c).

⁹ *Id.* § 1108(c). See generally Fischel & Langbein, *supra* note 2.

¹⁰ 29 U.S.C. § 1132(a)(2).

¹¹ *Id.* § 1132(a)(3).

¹² See generally Muir, *supra* note 5.

¹³ See *The Enron Pension Investment Catastrophe: Why It Happened and How Congress Should Fix It: Hearing Before the Senate Comm. on Governmental Affairs, Enron Hearings*, (2000) (statement of John H. Langbein, Professor, Yale Law School), available at http://www.senate.gov/~gov_affairs/012402langbein.htm [hereinafter *Statement of John Langbein*].

¹⁴ See S. REP. NO. 07-226, at 5 (2002), available at <http://thomas.loc.gov>.

Enron also made matching contributions to the Plan, up to six percent of an employee's compensation.¹⁶ The plan further specified that such contributions would be made in Enron stock, of which a plan participant had to hold until age fifty¹⁷ and at which point she could sell the stock and use the proceeds to invest in other investment vehicles.

Coupled with Enron's structure of matching contributions and employee allocation decisions respecting their own salary deferrals, approximately sixty percent of the total value of the Plan, at the beginning of 2001, was represented by Enron stock.¹⁸

Some Enron insiders, including Cindy Olson, Enron's Executive Vice-President for Human Resources and a member of the Enron committee that ran the Plan, were allegedly aware of Enron's vastly inflated trading value in 2001 (and in fact were selling their own shares of Enron stock).¹⁹ Despite this knowledge, neither Ms. Olson nor anyone else with fiduciary responsibility for the Plan considered either removing Enron stock as an investment option under the 401(k) plan, or selling Enron matching contributions. Instead, some of the insiders who were selling their own stock encouraged rank-and-file employees to continue holding Enron stock and to continue allocating elective deferrals into such stock.²⁰

II. LESSON ONE: PARTICIPANTS SHOULD NOT HOLD EMPLOYER STOCK IN THEIR RETIREMENT PLANS

The first lesson from Enron is the simplest—participants in qualified retirement plans should not be permitted to hold more

¹⁵ See *Statement of John Langbein*, *supra* note 13.

¹⁶ Enron's matching contribution was fifty percent of the employee's contribution, subject to a maximum of six percent of the compensation electively deferred by an Enron employee. *Id.* at n.4.

¹⁷ See S. REP. NO. 107-226, at 5 (2002), available at <http://thomas.loc.gov>.

¹⁸ See *id.*

¹⁹ See Amended Complaint, *Tittle v. Enron*, No. 01-CV-3919 (S.D. Tex. Filed Nov. 28, 2001) (on file with author).

²⁰ Another fact about the Enron disaster, which has received attention, was that Enron changed 401(k) record keepers in October, 2001, when the value of Enron stock was declining in the market. See, e.g., *Statement of John Langbein*, *supra* note 13. Employees were not permitted to change investment options during this period and thus were unable to dispose of their stock. Many, including the author of this Article, believe that scheduling a change of record keepers at this particular time was a clear breach of fiduciary duty. See *id.*

than an insignificant amount of employer stock in their retirement plan. ERISA already limits the amount of employer stock that can be held in any defined benefit pension plan,²¹ and this restriction should be extended to defined contribution plans.

Section 407 of ERISA limits pension plan investments in employer stock (and real property) to ten percent of plan assets.²² This rule does not apply, however, to "eligible individual account plans."²³ An "eligible individual account plan" is, with certain minor exceptions, any defined contribution plan that expressly provides for the acquisition and holding of employer securities.²⁴ As a result, employees can sometimes invest one hundred percent of their defined contribution account in employer stock²⁵—in effect, chasing a single rainbow with the hope of finding a pot of retirement riches at its end. Chasing rainbows, however, is no way to plan for retirement.

The key arguments against permitting employee retirement investment accounts to hold more than small amounts of employer stock are simple. A marvelous twentieth century economic discovery was the value of a well diversified investment portfolio, which helps protect investors from the possibility of large loss from industry and firm-specific failures, and at the same time allows participants to enjoy some of the risk premium for equity and other high risk or high return investments.²⁶ In financial planning for retirement, where excessive risk-taking is generally considered unwise, the value of diversification is not debatable. Moreover, professional guidelines generally prohibit professional investment managers from investing more than ten percent of a retirement plan's value in a single asset.²⁷

²¹ See ERISA § 407, 29 U.S.C. § 1107(a)(2) (2000).

²² *Id.*

²³ *Id.* § 1107(b).

²⁴ *Id.* § 1107(a)(2), (d)(3)(A).

²⁵ See generally EVERETT T. ALLEN, JR. ET AL., PENSION PLANNING: PENSIONS, PROFIT SHARING, AND OTHER DEFERRED COMPENSATION PLANS (4th ed. 1981).

²⁶ See *infra* note 49, testimony of Mr. Norman Stein; *Statement of John Langbein*, *supra* note 13 (pointing out that a well diversified portfolio can eliminate about seventy percent of investment risk).

²⁷ See generally bus.utk.edu/finance/Torch/Haslam/Objective%20and%20Policy%20Page.htm.9k; www.mcleanbudden.com/english/pdfs/Policies_Goals_July_14_00.pdf; www.braf.org/pdffiles/invst-ob.; www.braf.org/pdffiles/invst-obj&pol.pdf; www.hcm.com/hcm-cgi-bin/view-article?shw=11; <http://www.hcm.com/hcm-cgi-bin/view-article?show=11>.

Too much investment in a single security is bad, but too much investment in employer stock is worse. If the employer fails, the employee loses both retirement and job security. An economist would put it succinctly: an employee's investment capital and human capital should not be tied together. More colloquially, it is not a good idea to put all your eggs in one basket.

The fact that ERISA permits employers to invest substantial portions of their defined contribution accounts in employer stock does not, of course, require employers to design their plans to facilitate such investments. There are, however, both tax and non-tax benefits to firms whose retirement plans invest in employer stock. In the tax area, employers receive immediate deductions for plan contributions made in employer stock, even though there is no immediate cash cost to the firm.²⁸ Also, by setting up an Employee Stock Ownership Plan (ESOP), which can be grafted onto a 401(k) plan, a firm and its key employees can reap extraordinary additional tax benefits including employer deductions for dividends,²⁹ income tax exclusions for the seller of employer stock to the plan,³⁰ estate tax exclusions for an estate that sells employer stock to the plan,³¹ partial exclusion of interest payments to certain lenders to an ESOP,³² the equivalent of deductions for principal payments on a loan used to acquire employer stock,³³ and more generous contribution limits than for other types of defined contribution plans.³⁴ In addition, an ESOP that owns an S-Corporation can, in effect, avoid paying tax on business income.

Outside the tax area, there are obvious advantages of having "friendly hands" manage stock. An ESOP in a closely held firm can also create a market for the sale of stock.³⁵ In addition, some firms believe that employee stock ownership enhances firm

²⁸ See I.R.C. § 404(a)(3) (2000); see also *United States v. Gen. Shoe Corp.*, 282 F.2d 9, 14 (6th Cir. 1960) (concluding that the tax payer did not realize a taxable gain when it made the transfer); Rev. Rul. 73-583, 1973-2 C.B. 146.

²⁹ I.R.C. § 404(k).

³⁰ *Id.* § 1044.

³¹ *Id.* § 2057.

³² *Id.* § 133 (repealed 1996).

³³ See ALLEN, *supra* note 25, at 174-75.

³⁴ I.R.C. § 415(c)(6).

³⁵ See ALLEN, *supra* note 25, at 174.

stability and productivity, which is a belief that I will suggest is open to question.

Many employers respond to these benefits by establishing plans that require or permit investment in employer stock. For example, 94.7 percent of the assets in Proctor & Gamble's 401(k) plan, 81.6 percent of the assets in Anheuser-Busch's plan, and 74.3 percent of the assets of McDonald's plan are invested in employer stock.³⁶ Moreover, there are more than ten thousand ESOPs in which virtually one hundred percent of plan assets are invested in employer stock.³⁷

Despite Enron, and despite a virtual unanimity of opinion among investment professionals and academics of widely varying ideological perspectives against 401(k) plans holding employer stock,³⁸ there is active resistance in the pension industry toward legislation to enact meaningful limits on the amount of employer stock that an employee should be able to hold in his or her defined contribution plan. This resistance is hardly surprising given the advantages of employee stock ownership in qualified plans to the plan sponsor.

The arguments that the defenders of the status quo raise to such limits, and responses to these arguments, are described below.

³⁶ See S. REP. NO. 107-226, at 9 (2002), available at <http://thomas.loc.gov>.

³⁷ See The National Center for Employee Ownership, *A Statistical Profile of Employee Ownership*, at http://www.nceo.org/library/eo_stat.html (updated April 2002).

³⁸ See, e.g., *Hearing Before the Comm. on Educ. and the Workforce*, 107th Cong. 105-06 (2002) (statement of Dr. Teresa Ghilarducci, Ph.D., Associate Professor, Department of Economics, University of Notre Dame), available at <http://edworkforce.house.gov/hearings/107th/fc/enrontwo2702/ghilarducci.htm>; *Hearing Before the Senate Comm. on Governmental Affairs, Enron Hearings*, (2002) (statement of Susan J. Stabile, Professor, St. John's University School of Law), available at http://www.senate.gov/~gov_affairs/020502stabile.htm; *Hearing Before the Comm. on Educ. and the Workforce*, 107th Cong. 105-106 (2002) (statement of Norman Stein, Professor, University of Alabama School of Law), available at <http://edworkforce.house.gov/hearings/107th/ee/enronthree21302/stein.htm>; *The Enron Pension Investment Catastrophe: Why It Happened and How Congress Should Fix It: Hearing Before the Senate Comm. on Governmental Affairs, Enron Hearings*, 106th Cong. (2000) (statement of John H. Langbein, Professor, Yale Law School), available at http://www.senate.gov/~gov_affairs/012402langbein.htm.

1. *Respect for investor autonomy requires that employees be given the choice to invest in employer securities; education can mitigate the problem of non-diversification.*

Advocates against formal restrictions on employer stock argue that respect for investor autonomy makes limits on employer stock inappropriate, and that investor education can mitigate the problem of employees allocating excessive amounts of their investments in plans to employer stock. This argument is problematic: it suggests that we should accomplish indirectly through education what we could do more effectively and less expensively through regulation.

Investor autonomy is a powerful concept. It respects individual freedom and protects market integrity. There are certainly limits to how much the government can protect investors generally against the consequences of their own astigmatic judgments, but tax-favored retirement plans seem an appropriate venue for some governmental regulation of investment behavior—such plans are paternalistic devices whose purpose is to provide retirement income for plan participants. ERISA places numerous restrictions on pension plans that do not apply to investment intermediaries or investors generally. For example, Enron almost certainly would have violated ERISA's fiduciary requirements if it provided its participants with the option of investing one hundred percent of their funds in any single company in the world other than Enron, or if it permitted participants to invest part of their retirement savings by betting on number thirty-two in a roulette game at Atlantic City.³⁹

Why not educate participants about the undesirability of investing in employer stock rather than limiting investment in employer stock? As suggested, education involves resource expenditures (it is not free), will impose indirect costs (for example, employee time), is dependent on the quality of instruction and the aptitude of the student, and will sometimes be ignored by employees for reasons studied by behavioral economists.⁴⁰ Moreover, it may be naive to expect all or even

³⁹ See generally ERISA 29 U.S.C. § 1104(a) (2000).

⁴⁰ See generally Susan J. Stabile, *Freedom to Choose Unwisely: Congress' Misguided Decision to Leave 401(k) Plan Participants to Their Own Devices*, 11 CORNELL J.L. & PUB. POL'Y 361, 378–86 (2002) (arguing that although 401(k) plan participants make the investment decisions, their decisions are influenced by the

most such firms to make good faith efforts (and expend resources) to educate employees on the value of avoiding the very investment the firms would prefer their employees to make.

Perhaps the most sophisticated argument for education, rather than regulation, is that a limited number of employees have rational investment objectives in holding employer stock in a qualified plan. For example, an employee may have a well-diversified investment portfolio outside the plan and for tax reasons wishes to have the potentially high-return employer stock held in a tax-deferred format. Alternatively, the employee may have a well-diversified investment portfolio and the plan is the only venue in which a closely-held firm makes stock available to its employees. The argument is that by educating employees on the few situations in which it would be appropriate to invest in employer securities and allowing them to make the investment decision, employees for whom it is rational to sue their retirement plans to invest in employer stock would be able to do so without endangering the retirement income security of the majority of the people for whom concentration of retirement savings in employer stock would be inappropriate.

I do not find this argument compelling. For the reasons suggested earlier, I am skeptical about the efficacy of education to dissuade employees from investing their retirement plan assets in employer stock. A retirement policy should, in my view, place more of an emphasis on preventing avoidable disaster for rank-and-file employees, than in facilitating sophisticated investment strategies for a small group of affluent retirement-plan participants.

2. *Some employees do quite well in employer stocks.*

Some opponents of limiting the amount of employer stock in a 401(k) account have observed that some participants, who have chosen to allocate all or much of their plan investments to employer stock, have outperformed the market.⁴¹ This observation is closely related, but not identical, to the investor autonomy argument outlined above. The implication of this

choices presented to them and the manner in which those choices are presented to them).

⁴¹ See Sarah Hansard, *House Panel Gets Message: Don't Handcuff 401(k)s; Company Stocks Give Good Yields, Diversity*, INVESTMENT NEWS, Feb. 25, 2002, at 9.

argument is that limits on concentrations of employer stock will hurt, rather than help, many participants.

While it is true that some participants in defined contribution plans have prospered from their investment in employer stock, the volatility associated with an undiversified investment portfolio will produce losers as well as winners. In my view, retirement policy should be more focused on preventing losers (the avoidable disaster noted above) than in creating opportunities for employees to outperform the market.

3. *If forbidden to make matching contributions in employer stock or if employees are permitted to diversify out of employee stock too quickly, employers will stop making matching contributions all together.*

This argument reflects the questionable assumption that employers make matching contributions because they are “good guys” and not because the labor markets require them to provide retirement benefits to attract and retain workers. If employers stop matching contributions, they will find it more difficult to compete for good employees. Moreover, many firms that have adopted safe harbor 401(k) plans⁴² and SIMPLE plans⁴³ have to provide matching contributions in order to comply with the rules of those sections. Additionally, 401(k) plans subject to the ordinary testing rules generally must make matching contributions in order to induce non-highly compensated employees to contribute to the plan.⁴⁴ Without a high level of such contributions, highly compensated employees would be subject to restrictions on the amounts that they could elect to defer.

4. *Stock ownership aligns the interests of the firm and its workers, thereby increasing productivity and stability.*

The evidence on whether significant holdings of employer stock in an individual account plan increase productivity and firm stability is not conclusive. In addition, to my knowledge, none of the studies supporting this view control to support the significant tax benefits to the firm of such ownership.⁴⁵

⁴² See I.R.C. § 401(k)(12) (2000).

⁴³ See *id.* § 401(k)(11).

⁴⁴ See *id.* § 401(k)(3).

⁴⁵ See The National Center for Employee Ownership, *Employee Ownership and*

Moreover, even if the evidence in favor of productivity gains were less ambiguous than it is, there is a substantial question of whether the government should be privileging this type of compensation arrangement through tax subsidies—subsidies that can exceed those available to employers who sponsor retirement plans that do not permit investment in employer stock.⁴⁶ Finally, the tax subsidy for qualified plans is intended to improve retirement income security for working people, not to increase productivity within some firms.

If there are, indeed, productivity gains from concentrated employee ownership of a firm, firms should be willing, and are able, to provide stock ownership to employees outside of tax-subsidized retirement plans.

5. *Employee stock ownership results in employees investing in equity rather than debt, which gives employees access to the risk premium that equity investments have historically paid.*

The pension economist Jack Vanderhei has demonstrated that participants in plans that permit investment in employer stock have a greater propensity to invest in equity rather than debt. Historically, equity has outperformed debt and conventional wisdom says that investors with a long-term horizon, such as individuals saving for retirement, should allocate a substantial portion of their portfolio to equity securities. Thus, one can argue from Dr. Vanderhei's work that employer stock investment options encourages plan participants toward a more optimal allocation strategy.

Some economists and others, however, have questioned whether the greater historic returns of equity compared to debt should be expected to continue in the future.⁴⁷ There is no comparable debate on whether portfolio diversification will improve returns in the future. Given a choice between improved diversification of investment portfolios or greater increased preference for equity, one might well choose a policy that

Corporate Performance, at <http://www.nceo.org/library/corpperf.html> (noting studies showing that corporations with concentrated employee ownership outperform other corporations). *But see* Stabile, *supra* note 40, at 396 (stating that the "law provides employer pension plans with such favorable tax treatment, [and] at a considerable monetary cost").

⁴⁶ See *supra* notes 29–34.

⁴⁷ See generally Henry T.C. Hu, *Faith and Magic: Investor Beliefs and Government Neutrality*, 78 TEX. L. REV. 777, 830–37 (2000).

encourages the former, even at the expense of the latter.

Moreover, even if we were inclined to favor a strategy of increasing equity investment in defined contribution plans, there are ways of encouraging broadly diversified equity investment, such as education, that should be preferred to permitting investment in employer securities. If the government has a role in pushing investors toward equity investments, a point questioned by Professor Henry Hu in a recent issue of the *Texas Law Review*, there are more sensible ways of affecting this goal than a policy which results in an undiversified portfolio.⁴⁸

Despite what I view as a reasonably clear economic and policy case against concentrated retirement plan ownership of employer stock, I am not optimistic that Congress will change the statutory structure of ERISA to limit such ownership. The arguments against limits, while not persuasive, have provided politically powerful rhetoric for groups defending the status quo, particularly the argument for investor autonomy. The individuals and organizations advocating limits on employer stock must address the charges that they want to limit employee choice and that they need to protect American workers against their inclination toward improvidence. Furthermore, the most persistent advocates of limits are, for the most part, associated with academic institutions and lack the organizational and financial resources necessary to reshape the regulatory regime against the efforts of entities with an entrenched financial interest in maintaining the status quo.⁴⁹

The history of the debate thus far in Congress supports my pessimism. Senators Boxer and Corzine introduced legislation that would place percentage limits on the amount of investment an employee could make in employer stock.⁵⁰ Senator Kennedy proposed legislation that would have prohibited a 401(k) plan from offering employees an investment option in employer stock if the employer were also making matching contributions in employer stock.⁵¹ These proposals, none of which absolutely prohibited participant investment in employer stock and all of

⁴⁸ *Id.* at 884.

⁴⁹ *See, e.g., supra* note 37.

⁵⁰ Pension Protection and Diversification Act of 2001, S. 1838, 107th Cong. § 2, (2001), *available at* <http://thomas.loc.gov>.

⁵¹ Protecting America's Pensions Act of 2002, S. 1992, 107th Cong. § 102, (2001), *available at* <http://thomas.loc.gov/cgi-bin/query>.

which carved out broad exceptions for ESOPs, stimulated debate but have not found broad congressional support. Indeed, the only probable change in law that will reduce the aggregate of employer stock held in retirement plans is a proposed prohibition of any restrictions on selling employer stock in excess of a five-year holding period.⁵² While this would be an important provision, it would not have substantially mitigated the effect of Enron's collapse, where employees held on to Enron stock purchased with their 401(k) elective deferrals, stock which had not been subject to the restriction on sale.

III. LESSON 2: DEFINED CONTRIBUTION PLAN DESIGN SHOULD NOT SHIFT INVESTMENT ALLOCATION DECISIONS TO PARTICIPANTS

To some extent, the problems of too much employer stock in defined contribution plans are a result of a broader shortcoming of the regulatory scheme governing deferred compensation plans: ERISA section 404(c),⁵³ which limits the scope of plan sponsor's fiduciary responsibilities if the plan sponsor transfers responsibility for portfolio allocation to plan participants. Section 404(c) provides incentive for firms to abdicate their historic role of engaging investment professionals to manage plan investments.

Prior to ERISA's enactment, and indeed prior to the 1980s, most qualified plans—all defined benefit plans and most defined contribution plans—engaged professionals to manage the plan's assets. In today's world, however, most defined contribution plans have provided employees with the responsibility for portfolio allocation. In Enron, for example, employees had nineteen investment options to which they could allocate their elective deferrals.

Empirical research into how employees handle investment responsibility is not encouraging. The evidence suggests that employees are not very good at designing investment strategies (and why should we expect that the typical employee would be good at it?).⁵⁴ Some employees are too cautious, while others are

⁵² Pension Security Act of 2002, H.R. 3762, 107th Cong. §§ 210–11, (2002), available at <http://thomas.loc.gov>.

⁵³ ERISA § 404, 29 U.S.C. § 1104(c) (2000).

⁵⁴ See Stabile, *supra* note 40, at 381 (noting that employees can be manipulated by how the investment information is presented to them).

much too aggressive in the management of their retirement plan investments, as was the case with most participants in the Enron plan.

Professor Susan Stabile has forcefully argued that Congress should repeal section 404(c).⁵⁵ In her view, section 404(c) lacks adequate theoretical grounding because it is founded on the illusion that plans incorporating a participant-direction feature provide employees with meaningful control. In fact, participants often lack such control because the employer chooses the plan's investment options and determines the manner in which such options are presented to the employees. Moreover, participants may lack in investment experience and training and may suffer cognitive biases that impede rational investment allocation decisions.

Professor Stabile suggests that if Congress will not repeal section 404(c), it should at least require plans to have a broadly diversified default option from which they could affirmatively elect out. Such a default option might be a life-cycle investment fund, in which professional investment managers at chronological milestones in a participant's life adjust allocations.

There are currently no proposals before Congress that would either repeal ERISA section 404(c) or create a mandatory default option for participant-directed plans, as suggested by Professor Stabile. Congress is instead focused on encouraging plan sponsors to provide investment education to participants to assist them in formulating investment allocation strategies. The House has already passed legislation that would encourage the availability of investment advice by waiving certain fiduciary provisions that currently prohibit firms from selling investment products to the plan to furnish investment advice to participants.⁵⁶ Not surprisingly, this provision in the House legislation has been criticized as sanctioning conflicts of interest, since firms selling investment products would have an interest in steering participants to investments that serve the profitability of the firm rather than the retirement planning needs of the participant.⁵⁷ The House bill also permits the plan

⁵⁵ *Id.* at 401–02.

⁵⁶ Pension Security Act of 2002, H.R. 3762, 107th Cong. § 105, (2002) (enacted) available at <http://thomas.loc.gov>.

⁵⁷ See Democratic Policy Committee, *Pension Security Act of 2002*, available at <http://democraticleader.house.gov/uploads/020411FU pension.pdf>.

sponsor to bar investment advice concerning an option in the plan to invest in employer securities. Two Senate committees have reported legislation that would encourage the use of independent third parties, who are not otherwise affiliated with the plan, to provide investment advice.⁵⁸

Neither the House nor Senate approaches mandate investment education. But even if they did, education is problematic, as I suggested in the discussion of employer stock, because it is expensive and time consuming. Its quality varies depending on the educator, it is not be effective for all participants because of differences in participant experience and education, and it may not counteract powerful behavioral biases inclining people away from optimal investment behavior.

Moreover, the premise behind education rather than regulation is, itself, questionable. Proponents of education endorse the notion that there are correct, or at least preferable, investment strategies for people saving for retirement. Implicitly, these proponents argue that we should eschew regulatory solutions that would use professionals to design allocation strategies for all participants, for the more costly and less effective approach of educating tens of millions of individual investors on how to pursue optimal investment allocation strategies.

In addition to the more obvious arguments against relying on individual investors to manage their defined contribution investment strategies, a more subtle reason for discouraging participant-directed plans is the emotional burden it places on plan participants. This argument is eloquently captured in a cartoon by Don Wright of the Palm Beach Post two years ago, which is reproduced and spares the reader at least 1,000 words.

⁵⁸ See National Employee Savings and Trust Equity Guarantee Act, S. 1971, 107th Cong. § 306, available at <http://thomas.loc.gov>.



LESSON 3: CONFLICTED FIDUCIARIES WILL SOMETIMES SERVE THEIR INTERESTS RATHER THAN THE INTERESTS OF PLAN PARTICIPANTS

During the broad academic, popular, and legislative debates culminating with the passage of ERISA, there were fringe suggestions that plan sponsors and their agents should not be entrusted with the control and administration of employee benefit plans, since they might yield to their own conflicting interests. Congress rejected these concerns, expressly providing that its prohibited transaction rules shall not be “construed to prohibit any fiduciary from . . . being an officer, employee, agent, or other representative” of the plan sponsor.⁵⁹ Agents and employees of the employer are, of course, subject to ERISA’s rules regulating fiduciary behavior, including the rule that a fiduciary “shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries” of a plan.⁶⁰ It is questionable how effectively those rules operate when a fiduciary confronts difficult and substantial issues of conflict between the plan sponsors or between its own interests and those of the plan’s participants and beneficiaries.

Congressional hearings and a civil action brought by

⁵⁹ ERISA § 408(c), 29 U.S.C. § 1108(c) (2000).

⁶⁰ *Id.* § 404(a)(1), 29 U.S.C. 1104(a)(1) (2000).

participants in Enron's 401(k) plan suggest that the Enron employees who served as plan fiduciaries may have acted in their own interest rather than in the plan participants' interest. Several fiduciaries, including Cynthia Olsen and Kenneth Lay, knew that the market was overvaluing Enron stock because market participants were unaware how significantly the company's prospects were undermined by accounting fraud. Mr. Lay and Ms. Olsen sold their own Enron stock but did nothing to prevent plan participants from continuing to purchase additional Enron stock, or to prevent the plan from accepting and retaining additional Enron stock as matching contributions. Indeed, Mr. Lay encouraged participants to continue to invest elective contributions in Enron, pronouncing the company fundamentally sound when he knew, or had reason to know, that it was not. These actions helped support an inflated market value for Enron stock during a period of time when Mr. Lay and Ms. Olsen were sellers.

The lesson here is really one of human nature: people faced with sacrificing their own financial future in order to protect others may yield to temptation. Putting conflicted individuals in positions where they are required to make decisions and take actions pitting their interests against those of others is the Achilles' heel of ERISA's fiduciary law.

Unlike the first two Enron lessons, for which plausible statutory changes can be designed but probably not enacted because of political opposition, the lesson from Enron about fiduciary conflict does not lead to an easily conceptualized statutory modification. The most obvious approach to fixing the conflicted fiduciary problem is barring employers from serving as fiduciaries. This obvious approach, however, has obvious problems. The first problem is that it is too broad and expensive. In most situations employer fiduciaries are not problematic and bring knowledge of the firm and its workforce to plan administration. The cost of hiring independent fiduciaries is substantial and would make it difficult for plan sponsors to monitor and protect the firm's own interests in the plan. Thus, prohibiting employer representatives from serving as fiduciaries would add considerable expense to the costs of plan sponsorship while serving little purpose in quotidian plan administrative

matters.⁶¹

The second problem is that barring employers from plan fiduciary responsibilities would not necessarily spare participants from the consequences of every breach of responsibility by a conflicted fiduciary under today's statutory structure. Indeed, an independent fiduciary might not have been much help in reducing the losses of Enron employees, for such a fiduciary would not have been privy to the massive accounting fraud that led to Enron's collapse and might not have taken the actions that Enron employees contend was required of Mr. Lay and Ms. Olsen, precisely because they did know of the fraud. Furthermore, Enron would have, in the first instance, selected the independent fiduciary. If Enron selected the fiduciary and the fiduciary served at Enron's pleasure, how independent would it have been? One need look no further than Arthur Andersen for disturbing implications.

It would, of course, be possible to amend the statute to require an inside fiduciary to engage an independent ad hoc fiduciary in situations where the firm (or its management) has interests of its own that are at once substantial and in conflict with substantial interests of the plan's participants. Such situations should not be difficult for the inside fiduciary to identify, and an independent fiduciary chosen in such circumstances would be unlikely to favor the firm or its management over the participants, both because its attention would be focused on a single issue and because such a fiduciary would be cognizant of its own wealth being at risk if it favored the interests of the firm. Moreover, the statute could require that the independent fiduciary be unrelated to the firm and be barred from having any relationship with the firm for a lengthy period after serving as an independent fiduciary.

The problem with this approach is that the decision to appoint an independent fiduciary would still rest with the conflicted fiduciary. The responses of Enron officials to the various Enron scandals—concealment and covering up—suggest that the inside fiduciary might not recuse itself in favor of an independent fiduciary.

Such an approach might still offer some benefits. First, civil

⁶¹ See generally Fischel & Langbein, *supra* note 9, at 1117–19, 1126–28 (discussing the decline in the formations of plans that would likely result from the disqualification of employer representatives as fiduciaries).

litigation might be simplified if such a rule were adopted and if failure to recuse was itself a fiduciary breach and carried a presumption that the underlying decision was the cause of any financial loss. Second, there are situations involving conflicted fiduciaries that are sufficiently unlike Enron and such a rule might result in recusal of conflicted fiduciaries on occasion. In the much-discussed *Donovan v. Bierwirth*⁶² case, management fiduciaries purchased employer stock on the open market in order to fend off a hostile tender offer without concern that the stock might have been trading above its inherent value. The conflicted fiduciaries had not even considered recusing themselves but, we can speculate, might have in the shadow of an express rule mandating recusal where the fiduciary faces a substantial conflict between the interests of the firm and the potential interests of the participants. Such a rule could focus the attention of at least some fiduciaries on conflicts of interest, particularly if part of that focus was on the possibly ruinous financial consequences to the fiduciaries personally.

None of the congressional proposals that address Enron, however, attempts to deal with the systemic ERISA problem of the inside ERISA fiduciary acting on substantial matters when its objectivity is compromised by a conflict of interest.

V. A FINAL LESSON THAT MIGHT EMERGE FROM THE ENRON FIDUCIARY LITIGATION

Supreme Court ERISA jurisprudence creates questions about whether plan participants who brought a civil action against the Enron fiduciaries can recover damages, assuming that a court holds that the fiduciaries violated their statutory duties. The question arises because it is unclear that the plaintiffs can obtain monetary relief under ERISA's enforcement scheme.

Section 502(a) of ERISA includes two possibly relevant enforcement provisions. Section 502(a)(2)⁶³ permits a participant to recover, on behalf of a plan, losses to the plan and any profits made by a fiduciary using plan assets. The Supreme Court has held that section 502(a)(2) authorizes a derivative-type action, in

⁶² 680 F.2d 263 (2d Cir. 1982).

⁶³ ERISA, 29 U.S.C. § 1132(a)(2) (providing for the relief available in ERISA § 409).

which a participant can sue on behalf of a plan only.⁶⁴ A participant cannot bring an action under section 502(a)(2) to remedy a loss or harm suffered by the participant as an individual. The participants will argue that the losses caused by the Enron fiduciaries were suffered by the plan rather than by individual participants. The Enron fiduciaries, however, will argue that the losses were not “plan” losses because they occurred in individual participant accounts and at least the majority of the losses were the result of participant allocations of their elective contributions to employer stock.

Section 502(a)(3) of ERISA,⁶⁵ on the other hand, provides that a participant can bring a civil action to remedy a fiduciary breach, but that a prevailing plaintiff can only obtain “equitable relief.” The Supreme Court has held that “equitable relief” contemplates traditional equitable relief and does not generally include money damages.⁶⁶ In *Great-West v. Knudson*,⁶⁷ the Supreme Court held that equitable relief does not include money damages for a contract violation, nor does it include restitution unless the restitution is equitable in nature. The Court wrote that “a judgment imposing a merely personal liability upon the defendant to pay a sum of money” is not equitable relief.⁶⁸ The Enron fiduciaries have argued that any monetary remedy against them would be legal as opposed to equitable relief and unavailable under section 502(a)(3). The Enron participants, however, argue that monetary relief against a *breaching fiduciary* is a form of equitable relief. The Department of Labor has filed an amicus brief supporting the Enron participants’ section 502(a)(3) claim but not their section 502(a)(2) claim.⁶⁹

The federal courts may ultimately hold that the Enron participants cannot bring an action to remedy their losses under section 502(a)(2) because their action is not derivative in nature and that they cannot obtain monetary relief under section 502(a)(3) because their claim for such relief is not a form of equitable remedy. If courts were actually to hold this, Enron will

⁶⁴ See *Mertens v. Hewitt Assocs.*, 508 U.S. 248, 252–53 (1993); *Mass. Mut. Life Ins. Co. v. Russell*, 473 U.S. 134, 139–42 (1985).

⁶⁵ 29 U.S.C. § 1132(a)(3).

⁶⁶ *Great-West Life & Annuity Ins. Co. v. Knudson*, 534 U.S. 204, 220–21 (2002).

⁶⁷ *Id.*

⁶⁸ *Id.* at 213.

⁶⁹ See Amended Brief of the Secretary of Labor As Amicus Curiae Opposing the Motions to Dismiss in *Tittle v. Enron Corp.* (on file with author).

teach a fourth lesson, which is that ERISA's remedial sections let wrongdoing fiduciaries avoid meaningful liability for intentional harms.

Proposals to revise ERISA's remedial sections have been strongly opposed by employers and their trade groups and have not had traction in Congress. It should also be said that as substantial as the fortunes of some Enron fiduciaries might be, they will be inadequate to make participants whole even if the federal courts find them financially liable for the consequences of their behavior. But if they are held financially liable, others in their position might be more cautious in the future. Fear of personal ruin can be a powerful motivation.

VI. CONCLUSION

What happened in the Enron 401(k) plan reveals deep structural problems with ERISA, which is, after all, a statute designed to create and protect retirement savings for employees and their beneficiaries. These structural problems allowing employees to invest excessively in stock of their employer, allowing plans to shift investment decisions to employees, and permitting conflicted fiduciaries to make critical plan decisions are not being seriously addressed by Congress. Congress is instead considering a few modest changes on the periphery of the first problem, primarily requiring plans to permit employees in some circumstances to sell employer stock in situations where Enron employees could not. This is not a bad idea if we are going to continue to allow employers to make matching contributions in employer stock, but it does not address the problem that employees should not be investing their retirement savings in employer stock at all.

So, we watch Congress fiddle as ERISA's structural problems consume the retirement aspirations of America's working men and women.