Stock Market Volatility and 401 (k) Plans

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Many workers today depend on their 401(k) plan to provide them with an adequate income during retirement. For these workers to achieve retirement income security, their 401(k) plan investments must perform well over their working lifetime. Employers' selection of investment options for the 401(k) plan, a fiduciary duty under the Employee Retirement Income Security Act of 1974 (ERISA), plays a critical role in determining investment performance. In this Article, Professor Medill uses a series of hypothetical litigation scenarios to illustrate how interpretation of the employer's duty of prudence and duty of loyalty under ERISA present different policy choices for the federal courts. Professor Medill examines various hypothetical situations involving mutual fund fees and company stock where ERISA's duty of loyalty will require the federal courts to determine if an employer has received permissible incidental benefits or engaged in prohibited self-interested conduct when selecting 401(k) plan investment options.

Because employers today rely upon the Department of Labor's 404(c) Regulations to allow participants to select among plan investment options without incurring potential fiduciary liability, Professor Medill examines various policy issues likely to arise as federal courts interpret the details of the 404(c) Regulations. The Article cautions against judicial interpretations of the 404(c) Regulations that will have a potential chilling effect on voluntary plan sponsorship by employers. The Article also addresses an important exception to the 404(c) Regulations, the automatic enrollment plan. Professor Medill argues for a judicial interpretation of ERISA that encourages employers to select a default investment option for automatically enrolled participants that is broadly diversified in the equity markets, rather than a low-earning money market fund.

The Article concludes by examining the potential remedies available under ERISA for 401(k) plan participants injured by their employer's breach of fiduciary duty. Professor Medill concludes that, consistent with existing caselaw precedent, federal courts can and should afford injured 401(k) plan participants a remedy under ERISA.

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INTRODUCTION

When baby boomers realize they don't have enough money to retire, they might start suing their employers over the returns of the funds in their 401(k) plans. . . . It will eventually dwarf tobacco, firearms and other product liability litigation.1

Watching the daily performance of the stock market has become America's new national pastime. "What is the market doing today?" has joined workplace conversations devoted formerly to sports scores and political elections. With increasing regularity, the day's lead news story is another market correction or upsurge, or the falling fortunes of a newly public Internet company.2 Why have we, as a nation, become obsessed with the gyrations of the stock market? For many, the answer lies in that much of their personal wealth and the security of their future retirement is tied to the fortunes of the market through their employer-sponsored 401(k) plan.3

Widespread volatility in the stock market has come generally as a shock to many 401(k) participants accustomed to enjoying unprecedented investment returns on their retirement funds in recent years.4 Stock market volatility affects disproportionately employees whose future retirement income is linked to the financial fortunes of their employers through investments in company stock.

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3. The 401(k) plan takes its name from the Internal Revenue Code section from which it is derived. EMPLOYEE BENEFITS RESEARCH INST., FUNDAMENTALS OF EMPLOYEE BENEFIT PROGRAMS 93 (5th ed. 1997). In a 401(k) plan, the employee elects to have her employer contribute a portion of her compensation to the plan instead of receiving that compensation as current income. Id. at 94–95.
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5. See infra note 52.

6. Publications on the subject to date have focused narrowly on the technical legal requirements for participant directed 401(k) plans. See generally Keith R. Pyle, Compliance Under ERISA Section 404(c) with Increasing Investment Alternatives and Account Accessibility, 32 IND. L. REV. 1467 (1999) (analyzing the requirements of ERISA section 404(c) and assessing compliance difficulties resulting from a large number of investment alternatives and automated interaction by participants); Yolanda Sayles, Section 404(c) Plan Fees and Expenses: Is There an Affirmative Duty to Disclose?, 25 WM. MITCHELL L. REV. 1461 (1999) (arguing that courts should find in ERISA section 404(c) an affirmative fiduciary duty to disclose fee and expense information to plan participants).


participants who suffer significant investment losses are likely to seek relief in the federal courts.

The third scenario for future 401(k) plan litigation is distinctly different from the first two. Under this scenario, the stock market continues to rise. The 401(k) plan participants do not suffer an investment loss. Rather, the gravamen of employee complaint is that the participants suffered an opportunity loss. In other words, based on the stock market’s rising performance, their 401(k) plan accounts should have earned more than they actually did.

Under each scenario, the participants’ claims must be made under the Employee Retirement Income Security Act (ERISA),10 the federal statute that exclusively governs the rights of 401(k) plan participants and the responsibilities of the employers who sponsor them.11 This Article explores the issues that are likely to arise in future 401(k) plan litigation sparked by stock market volatility. ERISA’s statutory language itself is unhelpful. The key to resolving these issues lies in the federal regulations and caselaw that grant broad discretion to the federal courts.12 The exercise of this judicial discretion will, in effect, place the federal judiciary in a controversial policy-making role.

In his article, Judges As Advicegivers,13 Professor Neal Kumar Katyal describes one of the historical roles of the federal courts as giving advice on matters of public policy. He advocates this advice-giving role in the limited context of constitutional cases heard by the Supreme Court.14 Although lower federal court cases involving the interpretation of ERISA are certainly not as glamorous as constitutional litigation, Chief Justice Rehnquist himself acknowledged publicly that such cases are likely to be of much more practical importance.15

11. Title I of ERISA regulates all types of employee pension benefit plans, including 401(k) plans. 29 U.S.C. §§ 1002(3) (defining employee benefit plan), 1003(a) (defining ERISA’s coverage) (1994). Employee benefit plans sponsored for employees of federal, state or local governments or agencies or churches generally are excluded from coverage under Title I of ERISA. 29 U.S.C. § 1003(b) (1994 & Supp. II 1996). Unfunded executive deferred compensation plans, or “top hat” plans, are also excluded. Peter J. Wiedenbeck, ERISA’s Curious Coverage, 76 WASH. U. L.Q. 311, 342 (1998).
12. ERISA gives federal district courts exclusive jurisdiction over civil actions involving an employer’s breach of fiduciary duties under the statute. 29 U.S.C. § 1132(e)(1) (1994). The types of civil actions that may be brought by participants in a 401(k) plan for an employer’s breach of fiduciary duty are discussed infra Part II. No right to a jury trial exists for breach of fiduciary duty claims under ERISA; the federal district court judge acts as the trier of fact. A.B.A. EMPLOYEE BENEFITS COMM., EMPLOYEE BENEFITS LAW 634-35 (1991).
14. Id. at 1711.
15. In a 1997 speech at the dedication of the Harrison Law Grounds at the University of Virginia Law School, Chief Justice Rehnquist stated:
Judge Abner J. Mikva responds to Professor Katyal by arguing that a conscious practice of advice-giving by federal judges is inappropriate because "you could not find a group of people less experienced and less suited to legislative decisionmaking than federal judges." He contends that most judges prefer to avoid telling "policymakers how to make policy" by writing judicial opinions that omit nonessential dicta. Judge Mikva's assertion is true for policy issues under ERISA, a notoriously technical area of law.

Nevertheless, the federal courts, rather than Congress, usually have the final word on ERISA's fiduciary policy. Employers who sponsor retirement plans for their employees (or, perhaps more accurately, the highly specialized ERISA experts who counsel them) scrutinize judicial opinions for "advice" concerning an employer's fiduciary responsibilities and conform their behavior accordingly. Thus, no matter how narrowly a judge tailors her holding to the specific facts of the case, in ERISA matters, the primary audience will attempt to read "advice" into it. Worse, is the situation in which, although attempting to issue an opinion based strictly on the facts of the case, a judge unknowingly and inadvertently sends out policy signals to the employee benefits community. This unconscious advice-giving by the federal judiciary leads to unprincipled policy. Finally, the federal judiciary cannot rationalize its policy-making role on the assumption that Congress can always amend the statute. The statutory sections at issue in ERISA fiduciary litigation remain unchanged since their original enactment in 1974. Any attempts to amend these provisions will

If one examines the current offerings of the University of Virginia Law School, one learns that this year there are some 160 courses offered, and some 90 seminars. This is an intellectual feast that stands in sharp contrast, certainly, to the offerings of my law school when I attended long ago. When one looks further, one sees that there are at least three courses offered just on the First Amendment to the United States Constitution. By contrast, there seems to be no course offering devoted to federal regulation of employer-employee benefit and retirement plans—an area of the law which is much less glamorous, receives much less media attention, but the ramifications of which have a far greater effect on the daily lives of people than do the nuances of First Amendment law. Surely practitioners are much more likely to have clients with pension and benefit plan problems than with separation of church and state problems.

Chief Justice William H. Rehnquist, Address at the Dedication of the David A. Harrison II Law Grounds, University of Virginia (Nov. 8, 1997) (transcript on file with author).


17. Id. at 1826.

18. See England, supra note 8, at 74; Jacobius, supra note 8 at 6; Jacobius, supra note 9, at 61.
spark interest group battles of titanic proportions that will lead to the classic congressional response: inaction. 19

This pragmatic Article considers a third approach to advice-giving by the federal courts—one that lies somewhere between the positions of Professor Katyal and Judge Mikva. Unlike Professor Katyal’s elite area of constitutional law, ERISA is an area in which most federal judges would be the first to admit that their policy expertise, if it exists at all, is limited. Yet contrary to Judge Mikva’s view, the coming wave of 401(k) plan fiduciary litigation will thrust the federal judiciary, albeit perhaps unwillingly, into the role of shaping future national retirement policy. The federal courts’ “advice” will not be given to Congress, but primarily to the employers who sponsor 401(k) plans, and, more importantly, to the employee benefits experts who counsel them.

National retirement policy will be better served by a federal judiciary that is cognizant of the policy implications its decisions will have on future 401(k) plan litigation. This Article intends to sensitize the federal courts to the policy choices and ramifications that underlie the novel legal issues ushered in by today’s new world of stock market volatility and 401(k) plans.

Part I overviews the rise to prominence of the participant directed 401(k) plan. Part I also introduces the three primary fiduciary duties ERISA imposes upon employers who sponsor retirement plans: the duties of prudence, loyalty, and prudent diversification of plan assets.

Part II analyzes how each of these fiduciary duties potentially applies in the context of participant directed 401(k) plans. This analysis emphasizes the policy-making role the federal courts will play in interpreting and applying ERISA’s duties to employers who sponsor 401(k) plans. In Part II and continuing throughout the remainder of the Article, a series of hypotheticals are used to illustrate and discuss the legal issues and policy choices the federal courts will confront in future 401(k) plan litigation under ERISA.

Part II begins with an analysis of the employer’s duty of prudence in selecting the investment options for its 401(k) plan. This analysis is divided into two sections. First the employer’s decision-making process in selecting various mutual funds as investment options for its 401(k) plan is analyzed. Second, the additional factors an employer should consider if it also chooses to include

19. The aftermath of the Supreme Court’s decision in Mertens v. Hewitt Associates, 508 U.S. 248 (1993), is a prime example. Subsequent legislative attempts to override the Supreme Court’s narrow interpretation of the scope of employer fiduciary liability under ERISA section 502(a)(3) were abandoned in the face of interest group opposition. JOHN H. LANGBEIN & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 724–25 (2d ed. 1995).
company stock as an investment option for its 401(k) plan is examined. Next, Part II analyzes the employer’s duty of loyalty in selecting mutual funds and company stock as investment options. The close connection between fees and expenses to the employer’s selection of mutual funds for the plan’s investment options, and how this connection creates a potential conflict of interest for the sponsoring employer is also discussed. Another potential conflict of interest arises when an employer includes company stock as an investment option, which can lead to potential breaches of the employer’s duty of loyalty under ERISA.

Part II, finally, examines the duty of prudent diversification of plan assets. Here, the growing tendency among employers to automatically enroll their employees in 401(k) plans and the unique policy challenge that this relatively recent development present to the federal courts is addressed. Part II ends with a discussion of the employer’s regulatory defense to alleged breaches of the duty of prudent diversification in the context of participant directed 401(k) plans. This discussion also outlines the policy-making role the federal courts will play as they interpret and apply this employer defense in future 401(k) plan fiduciary litigation.

Part III analyzes the potential remedies available under ERISA for breaches of the employer’s fiduciary duties of prudence, loyalty, and prudent diversification of plan assets. It begins with an overview of Supreme Court jurisprudence concerning ERISA remedies. Part III then builds upon Part II by presenting a series of hypothetical scenarios where the federal courts must determine whether, given a breach of fiduciary duty by the employer, a remedy is available under ERISA to the participants in the employer’s 401(k) plan. Part III emphasizes the policy choices that the federal courts will be making as they interpret and apply ERISA’s remedy provisions to 401(k) plans.

I. BACKGROUND: HOW WE BECAME A “401(K) NATION”

ERISA, enacted in 1974,21 predates the authorization of the 401(k) plan.22 Nevertheless, ERISA’s fiduciary responsibility

provisions govern the conduct of employers who sponsor 401(k) plans. In addition, ERISA provides the exclusive remedies available to 401(k) participants when an employer breaches its ERISA fiduciary duties.

That ERISA was enacted prior to the development of the 401(k) plan is critically important, yet easily overlooked. The chronology explains in large part the interpretative difficulties and related policy choices the federal courts will confront in attempting to apply ERISA’s statutory provisions to employers who sponsor 401(k) plans. These interpretive difficulties and policy choices are described in Parts II and III below, but to set the stage, an overview of the participant directed 401(k) plan’s rise to prominence is necessary.

ERISA generally imposes fiduciary duties of loyalty, prudence, and prudent diversification of plan assets upon employers who sponsor retirement plans. ERISA’s duty of prudent diversification of plan assets historically presented a major obstacle to participant directed investments in 401(k) plans. In a 401(k) plan, an employee elects to contribute part of her compensation to the plan instead of receiving that money as current income. Because the plan is funded with an employee’s own money, many employees prefer to have a voice in how their retirement savings are invested. Employers were reluctant in 1974, however, to turn investment control for a traditional defined benefit plan over to their employees. Employers feared that ERISA’s duty of prudent diversification of plan assets would render them liable for investment losses suffered by participants who did not select a diversified range of investments for their 401(k) plan accounts.

This fear was well-founded. Numerous studies of participant directed investments in 401(k) plans indicate that, although plan investments may be diversified investments on an aggregate basis,
many individual participants do not select a diversified range of investments for the retirement funds in their accounts. As of 1996, ERISA exempts employers from liability for investment losses when plan participants control the investment of their individual retirement plan accounts. This statutory exemption, commonly referred to as section 404(c) of ERISA, provides as follows:

In the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over assets in his account, if a participant or beneficiary exercises control over the assets in his account (as determined under regulations of the Secretary)—

(A) such participant or beneficiary shall not be deemed to be a fiduciary by reason of such exercise, and

(B) no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant’s or beneficiary’s exercise of control.

Obviously, it was essential for the Department of Labor to issue regulations for an employer to qualify for the section 404(c) exemption. Until that time, the employer’s potential liability for participant directed investment losses was uncertain. These regulations (404(c) Regulations) were finalized in 1992.


33. This reference to persons who are otherwise fiduciaries includes the named plan fiduciary, who is typically the sponsoring employer or union. 29 U.S.C. § 1102(a) (1994). It also includes other plan fiduciaries, such as the plan’s trustee, under ERISA’s general definition of a fiduciary. Id. § 1002(21)(A).

34. 29 U.S.C. § 1104(c)(1) (emphasis added).


Since the issuance of the final 404(c) Regulations, participant directed 401(k) plans have become increasingly popular with both employers and employees. In turn, national retirement policy has become increasingly dependent on 401(k) plans. In 1984, the first year for which data is available, there were 7.5 million employees participating in 17,303 401(k) plans sponsored by their employers. By 1995, the number of 401(k) plans increased to 200,813, and the number of participating employees increased to 28 million. In that same year, fifty-five percent of all contributions to employer-sponsored retirement plans were to 401(k) plans. A 1999 study of 491 companies found that forty-one percent of 401(k) plans represented the employee's primary source of retirement income, an increase from thirty-five percent in 1995.

Significantly, almost all 401(k) plans today allow plan participants to direct the investment of their 401(k) plan retirement savings. Before turning to the fiduciary responsibilities ERISA places on employers who sponsor 401(k) plans, it is important to understand why the federal courts are just beginning to address these issues. The rise in popularity and prevalence of the 401(k) plan has coincided with the longest running bull market in the history of United States equity markets. Many new 401(k) plan participants were inexperienced investors and wrongly believed they possessed the Midas touch. Satisfied employees, in turn, made for compliant employers.

37. Employers favor 401(k) plans because, unlike other types of retirement plans, they are funded by the employees themselves through salary deferrals. See supra note 3. Employees like 401(k) plans because, unlike other types of retirement plans, the employee's retirement benefits are portable, and the employee has control over the level of her retirement savings and the investment of the retirement funds. PENSION & WELFARE BENEFITS ADMIN., U.S. DEP'T OF LABOR, STUDY OF 401(k) PLAN FEES AND EXPENSES § 1 (1998), available at http://www.dol.gov/dol/pwba.


39. Id.


44. See Banham, supra note 8, at 69–70.
Today's stock market volatility has upset the equilibrium. As a result, employees are beginning to scrutinize their 401(k) plans and to ask questions of their employers (and their own lawyers). Employers, many for the first time, are examining nervously their ERISA fiduciary responsibilities and potential liability in sponsoring 401(k) plans. What both groups will find, unfortunately, is a legal quagmire.

II. EMPLOYER FIDUCIARY DUTIES AND THE 404(C) REGULATIONS

A. Introduction to Litigation Scenarios

The 404(c) Regulations require that for a 401(k) plan participant to "exercise control" over the assets in her account, the plan must provide certain informational disclosures to the plan participants and must be designed to offer a broad range of diversified investment options. To satisfy these requirements, 401(k) plans usually offer mutual funds as plan investment options. The result has been a significant growth in both mutual fund participation and investment in the stock market by the average American worker.
The 404(c) Regulations also permit the employer to offer company stock as an investment option. A study of the investment choices made by 401(k) plan participants indicates that when company stock is offered as an investment option, 32.7% of employees select it as one of their investments. A significant number of these employees invest heavily in company stock, which is an investment strategy fraught with risk.

As 401(k) plan investments, both mutual funds and company stock are subject to stock market volatility. Consequently, litigation between employers and employees involving 401(k) plan investments is likely to arise under three scenarios. The first scenario involves a substantial and sustained downward correction in the stock market generally. The second scenario involves an employer who selects its own publicly traded company stock as an investment option for the 401(k) plan. If the market value of the company stock declines, so will the retirement savings of those employees who invested in the stock through the 401(k) plan. Under either of these first two scenarios, unhappy 401(k) plan participants who sustain significant investment losses may sue the plan's sponsoring employer for breach of a fiduciary duty under ERISA.

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50. 29 C.F.R. § 2550.404c-1(b)(3).
51. VAN DERHEIJ ET AL., supra note 30, at 11 (tbl.5); see also Medill, supra note 22, at 20-23 (discussing results of older studies on investment plans with company stock options). As of 1995, of the $773,941,000,000 in total assets held in 401(k) plans, $114,370,000,000, or 14.8%, were employer securities. PENSION & WELFARE BENEFITS ADMIN., supra note 38, at tbl.D6. A more recent private survey of employers found that as of 1997, thirty-seven percent of 401(k) plans offered company stock as an investment option. PENSION & WELFARE BENEFITS ADMIN., supra note 37, § 2.4.3.
53. For a discussion of potential ERISA claims and remedies for these litigation scenarios, see infra Parts II.B., III.
The third litigation scenario contemplates a continued spectacular rise in the stock market. Under this scenario, the participants' 401(k) plan investments do not lose money; rather, the participants' complaint is that the employer invested their 401(k) plan money too conservatively in a safe, but low-earning, money market mutual fund. As a result, their 401(k) plan accounts did not earn as much as they otherwise would have if the employer had invested more broadly in the stock market. The participants' alleged injury is one of a lost opportunity to share in the stock market's overall rise. This third scenario is made possible by a new and growing trend in the world of 401(k) plans: the development of the so-called "automatic enrollment" 401(k) plan.

In resolving these claims, the federal courts must, of course, defer to any reasonable Department of Labor interpretation of ERISA's statutory language if a court determines that the statute is silent or ambiguous on the issue.\(^5\) Consequently, in describing the current state of ERISA fiduciary law below, relevant Department of Labor regulations and official pronouncements are incorporated. What will become evident is that the Department of Labor, at key policy junctures, effectively delegated its own policy-making authority with respect to 401(k) plans to the federal courts.

\[ B. \text{ Breach of Fiduciary Duty Claims Against the Employer} \]

In its official commentary accompanying the 404(c) Regulations, the Department of Labor took pains to make clear that an employer's failure to comply with the requirements of the 404(c) Regulations is not, in itself, a breach of fiduciary duty by the employer.\(^5\) Consequently, the initial burden under all the litigation scenarios falls on the 401(k) plan participants to prove that the

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\(^5\) Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842-45 (1984) (holding that, when a statute is silent or ambiguous on a specific issue, courts should give deference to a reasonable interpretation adopted by the agency entrusted with administering the statute); Herman v. Nationsbank Trust Co., 126 F.3d 1354, 1363 (11th Cir. 1997) ("Unless Congress, in enacting ERISA, demonstrated clearly its intent with regard to the questions before us, we must defer to the Secretary's official interpretations of ERISA if they are reasonable."); cf. Sayles, supra note 6, at 1493-98 (arguing that the federal courts should impose an affirmative fiduciary duty of disclosure on employers beyond ERISA's § 404(c) regulatory requirements).

plan’s sponsoring employer breached one or more of its statutory fiduciary duties under ERISA section 404(a).\(^{56}\)

Participants in 401(k) plans are likely to allege three possible violations of the employer’s fiduciary duties: breach of the employer’s duty of prudence; breach of the employer’s duty of loyalty; or breach of the employer’s duty of prudent diversification of plan assets. The employer’s duties of prudence and loyalty are discussed below in Subparts B1 and 2. The employer’s duty of prudent diversification of plan assets is discussed in Subpart 3 in connection with the 404(c) Regulations.

1. The Employer’s Duty of Prudence in Selecting 401(k) Plan Investment Options

a. Established Legal Standards—ERISA section 404(a)(1)(B) requires the employer to discharge his duties with respect to a plan:

with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.\(^{57}\)

The legislative history states that lawmakers “expect[ed] that the courts will interpret this prudent man rule (and the other fiduciary

\(^{56}\) See 29 U.S.C. § 1104(a) (1994). ERISA’s statute of limitations for breach of fiduciary duty claims is unlikely to present a serious obstacle to the types of claims described in this Article. Under ERISA section 413, a breach of fiduciary duty claim against the employer must be brought within the earlier of:

(1) six years after (A) the date of the last action which constituted a part of the breach or violation, or (B) in the case of an omission, the latest date on which the fiduciary could have cured the breach or violation, or

(2) three years after the earliest date on which the plaintiff had actual knowledge of the breach or violation;

except that in the case of fraud or concealment, such action may be commenced not later than six years after the date of discovery of such breach or violation.

29 U.S.C. § 1113 (1994). The federal courts construe strictly the actual knowledge requirement of ERISA section 413(2) that triggers the shorter three year statute of limitations period. Brown v. Am. Life Holdings, Inc., 190 F.3d 856, 859 (8th Cir. 1999) (summarizing caselaw); Gluck v. Unisys Corp., 960 F.2d 1168, 1178 (3d Cir. 1992) (holding that actual knowledge requires more than mere knowledge that the transaction giving rise to the alleged breach occurred). The federal courts also have used the "continuing breach" theory effectively to extend the statute of limitations period. E.g., Starr v. JCI Data Processing, Inc., 767 F. Supp. 633, 636-38 (D.N.J. 1991); Dole v. Formica, 14 Employee Benefits Cas. (BNA) 1397, 1405-06 (N.D. Ohio 1991) (finding that each time the plans paid an excessive administrative fee, the plans were harmed and a new cause of action arose).

standards) bearing in mind the special nature and purpose of employee benefit plans.\textsuperscript{58} Thus, from the outset, Congress contemplated that the federal courts would incorporate policy considerations into their analysis of ERISA’s fiduciary duty standards.

Traditionally, ERISA cases interpreting the employer’s duty of prudence have arisen when an investment manager or other plan fiduciary, rather than the employees, has selected and managed the plan’s investments.\textsuperscript{59} Nevertheless, several general principles applicable to today’s participant directed 401(k) plan emerge from that well-developed body of judicial precedent.

First, an employer’s subjective good faith is not a defense—“a pure heart and an empty head are not enough” to satisfy the duty of prudence.\textsuperscript{60} Second, prudence is to be evaluated based on the circumstances at the time a decision is made.\textsuperscript{61} In particular, the eventual investment result, good or bad, does not establish compliance with or a breach of the duty of prudence.\textsuperscript{62} Third, the


\textsuperscript{59} See GIW Indus., Inc. v. Trevor, Stewart, Burton & Jacobsen, Inc., 895 F.2d 729, 730-31 (11th Cir. 1990); Fink v. Nat’l Sav. & Trust Co., 772 F.2d 951, 953-56 (D.C. Cir. 1985); Katsaros v. Cody, 744 F.2d 270, 273-80 (2d Cir. 1984); Donovan v. Mazzola, 716 F.2d 1226, 1228-31 (9th Cir. 1983). An exception is the case of In re Unisys Savings Plan Litigation, 21 Employee Benefits Cas. (BNA) 2514, 2516 (E.D. Pa. 1997), where the participants alleged that the employer breached its duty of prudence in purchasing guaranteed investment contracts (GICs) from Executive Life Insurance Company of California (Executive Life). The Executive Life GICs constituted approximately fifteen to twenty percent of one of the investment options in these participant directed retirement plans, one of which was a 401(k) plan. \textit{Id.} at 2516-17, 2518, 2530 (findings of fact numbers 1, 5, 15, and 79). When Executive Life later was placed into conservatorship by California insurance company regulators, the GICs eventually paid a lower rate of interest than called for in the purchase contract. In \textit{re Unisys Sav. Plan Litig.}, 173 F.3d 145, 150 (3d Cir. 1999). Although the In \textit{re Unisys} case applies the employer’s duty of prudence in the context of a participant directed 401(k) plan, its factual setting is unusual. The case does not address the more common types of factual situations presented in this Article. The case also predates the effective date of the final 404(c) Regulations. See Final Regulation Regarding Participant Directed Individual Account Plans, 57 Fed. Reg. 46,906, 46,906 (Oct. 13, 1992) (codified at 29 C.F.R. § 2550.404c-1).

\textsuperscript{60} Donovan v. Cunningham, 716 F.2d 1455, 1467 (5th Cir. 1983).

\textsuperscript{61} In \textit{re Unisys Sav. Plan Litig.}, 74 F.3d 420, 434 (3d Cir. 1996); Katsaros, 744 F.2d at 279; see also DeBruyne v. Equitable Life Assurance Soc’y, 720 F. Supp. 1342, 1349 (N.D. Ill. 1989) (stating “fiduciary duty of care requires prudence, not prescience”).

\textsuperscript{62} In \textit{re Unisys}, 74 F.3d at 434 (stating that the court is to focus on “a fiduciary’s conduct in arriving at an investment decision, not on its results”); Roth v. Sawyer-Cleator Lumber Co., 16 F.3d 915, 918 (8th Cir. 1994) (stating the “prudent person standard is not concerned with results”); Marshall v. Glass/Metal Ass’n & Glaziers, 507 F. Supp. 378, 384
employer may need to seek the assistance of outside experts prior to making plan investment decisions.  

The duty of prudence has both objective and subjective components. Subjectively, it is well established that the duty of prudence generally requires the employer to conduct a thorough investigation prior to making an investment decision. The regulations describe this employer duty as follows:

With regard to an investment or investment course of action taken by a fiduciary of an employee benefit plan pursuant to his investment duties, the requirements of section 404(a)(1)(B) of the Act . . . are satisfied if the fiduciary:

(i) Has given appropriate consideration to those facts and circumstances that . . . the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties; and

(ii) Has acted accordingly.

In evaluating the objective merits of an investment, "appropriate consideration" include[s], but is not necessarily limited to,

(i) A determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio . . . to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain . . . associated with the investment or investment course of action, and

(D. Haw. 1980) (noting "even the most carefully evaluated investments can fail while un-promising investments may succeed").

63. Martin v. Feilen, 965 F.2d 660, 670-71 (8th Cir. 1992); Donovan v. Bierwirth, 680 F.2d 263, 272-73 (2d Cir. 1982); Donovan v. Tricario, 5 Employee Benefits Cas. (BNA) 2057, 2064 (S.D. Fla. 1984). The employer cannot, however, rely blindly on the recommendations of an outside expert. Howard v. Shay, 100 F.3d 1484, 1489 (9th Cir. 1996); Cunningham, 716 F.2d at 1474; Mazzola, 716 F.2d at 1234.

64. Fink, 772 F.2d at 962 ("In short, there are two related but distinct duties imposed upon a trustee: to investigate and evaluate investments, and to invest prudently.") (Scalia, J., concurring and dissenting); Whitfield v. Cohen, 682 F. Supp. 188, 195 (S.D.N.Y. 1988).

65. In re Unisys, 74 F.3d at 434; Katsaros, 744 F.2d at 279.

Consideration of the following factors . . .

(A) The composition of the portfolio with regard to diversification;

(B) The liquidity and current return of the portfolio relative to the anticipated cash flow requirement of the plan; and

(C) The projected return of the portfolio relative to the funding objectives of the plan.

Finally, the federal courts have long viewed duty of prudence as a highly flexible standard, to be "evaluated in light of the 'character and aims' of the particular type of plan [the fiduciary] serves." Many of these general principles, developed in the context of plans where a fiduciary selected the plan's investments, can be transferred to today's participant directed 401(k) plan. The logical corollary in the 401(k) plan setting is the employer's selection of investment menu options from which the participants will make their investment choices. The Department of Labor imposes minimal requirements for the range of investment options that must be offered in participant directed 401(k) plans. As a result, the employer has broad discretion in selecting these investment options.

This exercise of employer discretion in selecting the investment options for the 401(k) plan is a fiduciary function subject to the general duty of prudence. In the official commentary to the 404(c) Regulations, the Department of Labor emphasized that the act of designating investment alternatives . . . in an ERISA section 404(c) plan is a fiduciary function to which the limitation on liability provided by section 404(c) is not applicable. All of the fiduciary provisions of ERISA remain applicable to both the initial designation of investment alternatives . . . and the ongoing determination that such alternatives . . . remain suitable and prudent alternatives for the plan.

67. Id. § 2550.404a-1 (b)(2).
68. In re Unisys, 74 F.3d at 434 (quoting Cunningham, 716 F.2d at 1467).
69. See infra II.B.3.
Thus, compliance with the 404(c) Regulations is not a defense to an employer’s breach of the duty of prudence (or duty of loyalty) in selecting and monitoring the 401(k) plan’s menu of investment options.

An employer, of course, may argue that its selection of investment options for the 401(k) plan is a plan design decision made in the employer’s nonfiduciary capacity as “settlor” of the plan. However, in interpreting this employer duty as a fiduciary one, the Department of Labor anticipated and expressly rejected the settlor function argument. The federal courts should do likewise.

b. Policy Choices: Employer Burden Versus Participant Protection—The following hypothetical and discussion introduce application of the duty of prudence to the employer’s selection of investment options in a 401(k) plan. This hypothetical is used and developed throughout the Article to articulate the broad policy considerations that the federal courts face in interpreting and applying ERISA’s fiduciary provisions to 401(k) plans.

FIRST HYPOTHETICAL

Employer decides to establish a participant directed 401(k) plan. Employer goes to Full Service Provider, who furnishes both the necessary plan documents and administrative services for the 401(k) plan. The Full Service Provider also sponsors various mutual funds that are potential investment options under the plan. Employer selects seven of these mutual funds—four equity funds, two bond funds, and a money market fund—as the investment options for the 401(k) plan.

The question presented to the federal court is whether Employer has satisfied its fiduciary duty of prudence in selecting these investment options.

The first hypothetical represents the most common approach to 401(k) plan sponsorship by employers. All but the largest employ-
ers who sponsor 401(k) plans generally use what is known as a "full service provider" for "one-stop shopping" in establishing and administering their 401(k) plans.\textsuperscript{74} The hypothetical "Full Service Provider" represents the mutual fund companies, large banks, and insurance companies who offer these services.\textsuperscript{75}

The question presented to the federal court in this hypothetical introduces the first set of broad policy choices that arise in 401(k) plan fiduciary litigation. On one hand, ERISA makes retirement plan sponsorship by employers voluntary.\textsuperscript{76} Consequently, the fiduciary duties (and corresponding potential liability for breach) imposed upon employers should not be made so burdensome that employers will be deterred from offering retirement plans to their employees.\textsuperscript{77} On the other hand, a principal purpose of ERISA's fiduciary provisions is to protect the integrity of plan assets and the retirement plan benefits provided to plan participants.\textsuperscript{78} The more stringently these fiduciary duties are enforced, the greater the protection to plan participants. This first set of policy choices is referred to as "employer burden versus participant protection."

Employer burden is a particularly sensitive policy concern in the 401(k) plan context. The statistical trends show that 401(k) plans are quickly becoming the most prevalent type of retirement plan offered by employers.\textsuperscript{79} Larger and more well-established employers tend to offer 401(k) plans in addition to other types of retirement plans.\textsuperscript{80} But smaller and newer employers tend to offer only 401(k) plans.\textsuperscript{81} For this latter group in particular, the only viable economic choice may be between offering employees a 401(k) plan or no retirement plan at all.\textsuperscript{82} Consequently, a potential policy concern is whether imposing too great of a fiduciary burden may deter these smaller employers from offering 401(k) plans.\textsuperscript{83}

\begin{itemize}
\item \textsuperscript{74} Pension \& Welfare Benefits Admin., supra note 37, § 2.7 (reporting that eighty-five percent of 401(k) plans with fewer than 250 participants and seventy-five percent of 401(k) plans with 250 to 1,000 participants use a full service provider).
\item \textsuperscript{75} See id.
\item \textsuperscript{76} H.R. Rep. No. 93-533, at 1 (1974), reprinted in 1974 U.S.C.C.A.N. 4639, 4639; see also In re Unisys Sav. Plan Litig., 74 F.3d 420, 434 (3d Cir. 1996) (holding that one of ERISA's underlying purposes is to encourage the development of private retirement plans).
\item \textsuperscript{77} Varity Corp. v. Howe, 516 U.S. 489, 497 (1996).
\item \textsuperscript{79} See supra notes 38-41 and accompanying text.
\item \textsuperscript{80} See Pension \& Welfare Benefits Admin., supra note 38, at tbl.D4.
\item \textsuperscript{81} Id.
\item \textsuperscript{82} Paul Yakoboski et al., Employee Benefit Research Inst., The Gallup Org., Inc., Issue Brief No. 212, The 1999 Small Employer Retirement Survey: Building a Better Mousetrap Is Not Enough 3 (1999) (finding that only thirty-one percent of individuals who work for employers having fewer than 100 employees have a retirement plan).
\end{itemize}
plans to their employees, thereby leaving these employees without a retirement plan.

A recent survey of small employers by the Employee Benefits Research Institute attempted to discern the reasons why this particular group sponsored or refused to sponsor retirement plans for their workers. 83 Contrary to the conventional wisdom, the survey results suggest that the administrative costs associated with plan sponsorship are not a dominant factor in the small employer's decision. 84 Rather, the two most important factors are the competitive advantage that offering a retirement plan gave the employer in employee recruitment and retention, and the positive effect on employee attitude and performance. 85

This information concerning small employer behavior is important because the employer's fiduciary duty of prudence will impact the employer's cost of plan sponsorship. The survey evidence indicates that the federal courts need not set the standard for prudence unnecessarily low out of a fear of chilling future 401(k) plan sponsorship among small employers because competitive advantage, not altruism, plays the greatest role in employer's decisions to sponsor 401(k) plans. In the 401(k) plan setting, prudent investigation in the beginning is relatively inexpensive, whereas protracted fiduciary litigation (and potential employer liability) after the fact is not. What is needed are clear guidelines from the federal courts to the employee benefits community delineating the employer's duty of prudence in selecting the investment options for a 401(k) plan. 86

Participant protection, too, has an important policy role in the 401(k) plan setting. A 401(k) plan that offers employees a carefully selected range of investment options is likely to maximize the potential for achieving retirement income security. 87 At retirement, a 401(k) plan participant's benefit will be the balance of her plan account, much which will be attributable to the tax-deferred compounding of investment earnings over a long period of time. 88 Consequently, the returns generated by the investment options available to the participant under the plan will play a large role in determining her retirement benefit. Conversely, fees and expenses

83. Id. at 1.
84. Id. at 5.
85. Id. at 6-7.
86. See Jacobius, supra note 9, at 61.
87. Lucchetti, supra note 49.
charged to the participant's account will erode significantly her investment earnings and, ultimately, the amount of her retirement benefit. 89

c. Policy Analysis: Employer's Duty of Prudence in Selecting Investment Options—The greatest challenge facing the federal courts in 401(k) plan fiduciary litigation will be interpreting and applying an established body of legal precedent, the ERISA fiduciary duties, to a new and unforeseen context. This task requires a fresh look at the legal standards used to evaluate fiduciary conduct under ERISA.

In the discussion below, established legal standards for evaluating an employer’s duty of prudence are reframed in the form of a question. Each question represents the same basic query: How should this legal standard apply to 401(k) plans? Following each question is a discussion and analysis of the competing policy considerations that the federal courts may want to consider in determining how the established legal standard should be applied in the 401(k) plan context.

Should the Employer have consulted an outside expert before selecting the 401(k) plan’s mutual fund investment options? Or does the Employer have the in-house expertise to make investment selections?

Caselaw indicates that the duty of prudence requires an employer who lacks investment expertise to seek outside expertise before investing the assets of the plan. 90 But is there a compelling policy reason to change this standard when the employer is selecting the investment options that will be available to 401(k) plan participants? The importance of the employer’s decision to the ultimate value of the 401(k) plan’s retirement benefits is obvious. 91 But is the corresponding burden on the employer so great that it justifies lowering the standard? Here employer size is a factor meriting consideration. In general, large employers are more likely to have sufficient in-house investment expertise to prudently select a range of investment options for the 401(k) plan. Consequently, the real impact of the duty is most likely to fall on smaller employers.

A Department of Labor industry advisory group (Working Group) has indicated that the first question a plan fiduciary should ask itself when selecting a service provider is, “What service or

89. See infra pp. 492-95, 503 and notes 104, 151.
90. See supra note 63.
91. See supra note 88.
expertise does the plan need? The real problem, hinted at by the first hypothetical, is that many employers, but particularly small employers, are heavily reliant on their 401(k) service providers. This practice underlies a significant, yet unanswered, policy question: Should a "suggestion" of investment options made by a representative of the service provider satisfy the Employer's fiduciary duty to seek outside expertise? The Department of Labor's Working Group does not address this question. Analysis of this policy question at this juncture is premature, as several additional factors must first be considered.

Should the Employer have considered and compared various Full Service Providers before reaching a decision?

Common sense dictates that the employer consider and compare two or more service providers before settling on one to assist the employer in servicing the 401(k) plan and, more importantly, furnishing the plan's investment options. After all, in handling their own affairs, people generally do not buy the first car they see, nor the first house they are shown. They shop, they compare, and then they choose. Selecting a service provider for a 401(k) plan is a fiduciary function, historically subject to "'[n]ot honesty alone, but the punctilio of an honor the most sensitive, ... [as] the standard of behavior.'" Yet the Department of Labor's Working Group found that

[m]any of the problems with respect to service providers arise because the responsible plan fiduciary either does not understand his role and responsibility in the selection and monitoring of service providers or exercises poor judgment because he does not have experience or an appropriate source of information concerning legal requirements and industry practices.

This finding, made by the Working Group in 1996, appears to be primarily directed at problems arising in the context of single-
employer defined benefit plans. Since that time, however, the regulations indicate that this basic fiduciary responsibility also applies in the context of selecting and monitoring the service provider for a 401(k) plan.

Did the Employer consider and compare the historical rates of return offered by various investment options? Their volatility? Their liquidity? The fees and expenses charged by the Full Service Provider to plan participants? Does the overall “package” of investment options offered by the plan offer a participant the ability to construct a diversified portfolio?

Requiring the employer to evaluate such factors as historical rates of return, liquidity, and volatility in selecting investment options is not as burdensome as it may first appear. The 404(c) Regulations in effect require the employer to consider these factors. This information is readily available, if requested, from the service provider who will provide the investment options for the 401(k) plan. The employer, however, may not have the investment expertise to analyze prudently this information.

In contrast, information concerning the fees and expenses charged to the plan participants may prove difficult to obtain and even more difficult to analyze and compare. The Department of Labor’s Working Group recommends that a plan fiduciary ask the following question when selecting a service provider: “Are the service provider’s fees reasonable when compared to industry standards in view of the services to be performed, the provider’s qualifications and the scope of the service provider’s responsibility?” Yet a 1998 Department of Labor study of 401(k) plan fees and expenses found that obtaining such information is difficult.

The costs of 401(k) plan services are somewhat dependent on the information that a plan sponsor has about the range of prices in the marketplace that are charged by these providers. A search of the literature shows that gaining visibility of the universe of thousands of service providers would be difficult to impossible for any plan sponsor with limited resources. For example, Valletta (February 1997) estimates that there are in

97. Id.
98. 29 C.F.R. § 2509.96-1(e) (2000).
99. See infra Part II.B.3.b.
100. See PENSION & WELFARE BENEFITS ADMIN., supra note 45, § 8.
excess of 1500 third party administrators and over 3,000 firms offering asset management services to 401(k) plans.

The directories cited offer only a small segment of the available vendors, although the majority of the larger providers are displayed. For example, the 401(k) Provider Directory, one of the best known, only contains information about 94 of the larger full service providers (HR Investment Consultants). The other directory located in the literature search, the (k)form Catalog, contains information about both full service providers as well as TPAs [third party administrators] and alliances. However, the (k)form Catalog lists only 79 such providers. (The publisher states that these 79 providers service over 50% of 401(k) plans in the country.)

Information about service providers is also available from associations, advertising, and the Internet. In addition, the 401(k) plan provider industry is very aggressively seeking to make their services known, frequently through well structured sales networks. However, the plan sponsor relying solely on information furnished by those service providers that establish contact through a sales force, would have incomplete knowledge of the marketplace.

The foregoing discussion suggests that the market for 401(k) plan services is not particularly efficient for the plans that do not have the resources or interest to search for information that would allow a comparison of available services and prices.102

Although obtaining comparable data on fees and expenses is burdensome to the employer, the need to protect plan participants may be even greater. The Department of Labor’s 1998 study found that “a substantial portion of 401(k) plan fees and expenses are charged against the account balances of plan participants and that this trend is increasing.”103 The study described the implications of this trend as follows:

102. Pension & Welfare Benefits Admin., supra note 37, § 2.7.4; see also id. § 3.7 (discussing whether plan sponsors and participants are adequately informed about fees and expenses); Terry R. O’Neill, It Pays to Know About Both Qualified and Nonqualified Programs, Employee Benefit Plan Rev., Apr. 1, 2000, at 41, 42 (describing when 401(k) plan fees may be hidden); Stephen B. Whipple, 401(k): Savings Plan or Shell Game?, A.B.A. Banking J., Apr. 1, 2000, at 79, 79 (same).

Expenses of operating and maintaining an investment portfolio that are debited against the participant’s account constitute an opportunity cost in the form of foregone investments in every contribution period. The laws of compound interest dictate that these small reductions in investment are magnified greatly over the decades in which many employees will be 401(k) plan participants. Observers have concluded that some plan providers are charging as much as 100 basis points in fees and expenses over the prevailing average rates (citation omitted). The effect of such higher levels of expenses would be to reduce the value of potential future account balances for these participants.

An example in Forbes Magazine shows this effect. Two employees each contribute the same amount annually into mutual funds. The funds each return 9% annually, but one has an expense ratio of 0.2% while the other has an expense ratio of 1.2%, a difference of 100 basis points. At the end of 35 years, the less expensive fund has a balance 23% higher than the other (citation omitted).

Some observers postulate that some plans are paying fees and expenses that are too high. Evidence for this conclusion is offered by studies that show extraordinary variance in price quotations given by providers for essentially comparable services (citations omitted). It has been argued by these observers that, when a plan incurs higher fees and expenses, the plan sponsor has not exercised adequate care in selecting and monitoring the plan’s service providers.

A second issue of concern to many observers is that sponsors (and participants) lack adequate information on the structure and extent of fees and expenses to make informed choices about service providers and investment options. Thus, the inadequate disclosure of information may be a factor in the existence of the large variance in fees and expenses of 401(k) plans.104

The Department of Labor study found that the single largest type of expense being charged to 401(k) plan participants was investment management fees.105 Investment management fees are

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104. Id. § I.
105. Id. § 3.3.4.
deducted at the mutual fund level to compensate the service provider for managing the assets held in the mutual fund. The study found that investment management fees exceed eighty percent of a typical 401(k) plan's total fees and expenses.

The potential for mischief when an employer relies on a service provider representative for expert advice in selecting plan investment options should now be evident. Although the Securities and Exchange Commission requires disclosure of investment management fees, such disclosure may be meaningless to an employer. Are the fees high, average, or low for the industry? The service provider representative may know the answer to this question, but it may not be in the representative's self-interest (or the interest of the representative's employer, the service provider) to opine on the subject. If fees are disclosed as relatively high, the service provider may lose a customer, and the representative may lose a sale.

Does this mean that 401(k) plan participants should go unprotected? Can the burden on the employer to investigate fees and expenses be mitigated? The answer to both of these questions lies in full disclosure of industry standards for 401(k) plan fees and expenses. Today's employer does not need to investigate independently industry standards for fees and expenses, since the Department of Labor compiled and posted this information on the internet, as have other independent sources. With literally one click, the employer can evaluate whether the fees and expenses of the service provider are "low," "high," or "average" when compared to industry standards. In addition, the Department of Labor developed a standardized questionnaire to assist employers in making meaningful comparisons of the fees and expenses charged by various 401(k) plan service providers.

106. Id. Due to ERISA's complex prohibited transaction rules, receipt of these investment management fees prevents the plan service provider from providing investment advice to the 401(k) plan participants. See generally Medill, supra note 22, at 38-46 (discussing ERISA's prohibited transaction rules and exemptions).

107. PENSION & WELFARE BENEFITS ADMIN., supra note 37, § 3.3.4.

108. Id. § 2.4.1.1; Medill, supra note 22, at 44-46 and accompanying notes.

109. Indeed, the founder and former chief executive officer of Vanguard Group has criticized publicly the greed, in the form of higher fees, that has invaded the mutual fund industry. John C. Bogle, How Mutual Funds Lost Their Way, WALL ST. J., June 20, 2000, at A26.

110. PENSION & WELFARE BENEFITS ADMIN., supra note 37, § 4.2-3.


112. See infra notes 165-66 and accompanying text.
Service provider fees and expenses charged that border on the abusive are now a Department of Labor enforcement priority. The federal courts should consider the growing availability of this information in determining whether an employer has acted prudently.

Did the Employer periodically review the plan's investment options to determine if they should continue to be offered or instead should be changed?

The Department of Labor's position is that the employer has an ongoing fiduciary duty to monitor the investment options offered under the 401(k) plan.

[T]he Department points out 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 which, whether achieved through fiduciary designation or express plan language, is not a direct or necessary result of any participant direction of such plan. Thus, for example, in the case of look-through investment vehicles [mutual funds], 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 upon that evaluation, whether the vehicles should continue to be available as participant investment options.

There are sound policy reasons underlying this duty to monitor the plan's investment options. As John Bogle, founder and former chief executive officer of Vanguard Group observes:

During the 1990s, 55% of equity funds failed, almost four times the 14% failure rate of the 1960s. Should the recent failure rate hold, 2,500 of today's 4,500 equity funds won't be around in 2010.

The employer's fiduciary duty to periodically review the 401(k) plan's investment options raises the hidden policy question posed

113. See infra note 152 and accompanying text.
115. Bogle, supra note 109. Insurance companies, too, are subject to failure. See supra note 59 discussing In re Unisys.
at the beginning of this section. If an employer lacks the expertise to evaluate a plan's investment options, is it prudent for the employer to rely on the service provider's sales representative for such expertise? By now it should be apparent why such reliance may well be imprudent during either the initial selection or a periodic review of the plan's investment options. The service provider's financial interests in obtaining and retaining the employer's 401(k) plan business are in direct financial conflict with its interest in providing a candid analysis of the performance of the service provider's investment options. Employers cannot prudently rely on a service provider's opinion of its mutual funds performance or the competitiveness of its fees and expenses. ERISA's duty of prudence should require the employer either to use its own in-house expertise to make this evaluation or to seek the assistance of an unbiased outside expert.

d. Policy Choices: The Employee Ownership Dilemma—The second hypothetical introduces another set of policy choices that federal courts are likely to confront in 401(k) plan fiduciary litigation. These policy issues arise when the employer includes company stock as an investment option in its 401(k) plan. Here, the underlying potential conflicts of interest stem not from the plan's service provider, but from the employer itself.

SECOND HYPOTHETICAL

**Employer decides that, in addition to selecting seven mutual funds as investment options for its 401(k) plan, it will also include as an investment option its own publicly traded stock. The question presented to the federal court is whether Employer has satisfied its fiduciary duty of prudence by selecting company stock as an investment option.**

The "employee ownership dilemma" is introduced by the second hypothetical. In this instance, the dilemma is not whether to encourage employee ownership as a matter of national economic policy; rather, it is whether, as a matter of national retirement policy, we want to use tax-favored 401(k) plans as a vehicle to promote employee ownership.

The traditional retirement plan vehicle used for promoting employee ownership is the employee stock ownership plan (ESOP).\footnote{116. **Employee Benefits Research Inst., supra** note 3, at 103–10; see also I.R.C. § 409 (1994); Treas. Reg. § 54.4975-11 (as amended in 1979).}
ERISA expressly exempts ESOPs from both the duty of prudence as it relates to plan investments in qualifying employer securities and the duty of prudent diversification of plan assets. These exemptions are necessary because the assets of the ESOP must be invested primarily in employer securities for it to qualify for favorable tax treatment under the Internal Revenue Code. The policy justifications for ESOPs, however, are not applicable to 401(k) plans.

ESOPs can hold stock of a company that is not traded on a national securities exchange. Thus, ESOPs offer employees of privately held companies, who otherwise would not be able to purchase company stock, a unique opportunity to share in the ownership of their employer. By contrast, the requirements of the 404(c) Regulations mandate that 401(k) plans hold only company stock that is publicly traded on a national market. Thus, a 401(k) plan with company stock as an investment option cannot be justified on the ground that it offers employees the sole opportunity to share in the ownership of their employer because the stock can be purchased outside the company 401(k) plan. Rather, the employee ownership dilemma presented by 401(k) plans is whether, as a matter of national retirement policy, the purchase of publicly traded company stock by employees should be encouraged through the use of pre-tax dollars contributed to a 401(k) plan.

ERISA's statutory language provides mixed signals as to how the federal courts should approach the employer's selection of company stock as an investment option for 401(k) plans. ERISA section 404(a)(2) provides:

In the case of an eligible individual account plan, the ... prudence requirement (only to the extent it requires

118. Id. § 1107(d)(3)-(d)(4).
122. An "eligible individual account plan" is defined in ERISA section 407(d)(3) to include profit sharing, stock bonus, thrift, savings, employee stock ownership, and certain money purchase plans. 29 U.S.C. § 1107(d)(3) (1994). This definition includes a 401(k) plan. See id. The prohibited transaction rules of ERISA section 407, however, may restrict the value of employer qualifying securities attributable to elective deferrals to not more than ten percent of the value of all plan assets attributable to elective deferrals if certain criteria are met. Id. § 1107(a)(2). These criteria are threefold: (1) a portion of the plan's elective deferrals or earnings thereon are required to be invested in qualifying employer securities under the terms or the plan or at the direction of someone other than the
... is not violated by acquisition or holding of ... qualifying employer securities.

Section 404(a)(2) can be read as creating a "strong policy and preference in favor of investment in employer stock." Yet the language of the statute clearly eliminates only one factor—diversification—from consideration in evaluating the employer's compliance with the duty of prudence. Other factors relevant to whether the employer has satisfied its duty of prudence remain. Perhaps the name of the legislation itself is instructive: the Employee Retirement Income Security Act. There is compelling evidence that encouraging company stock as an investment option in 401(k) plans is unlikely to promote income security during retirement. While a few lucky employees will be big winners, many others will be big losers.

The potential investment risk presented by company stock argues for a relatively high standard of prudence for employers who choose to include their own stock as a 401(k) plan investment option. From the perspective of protecting plan participants, the policy argument in favor of close scrutiny is reinforced by the absence of federal insurance in the event of employer insolvency. If the employer fails, so does the participant's 401(k) plan investment in company stock.

participant; (2) the portion of elective deferrals required to be invested in qualifying employer securities exceeds one percent of the employee's compensation used to determine the employee's maximum allowable elective deferrals under the plan for the year; and (3) the fair market value of all individual account plans (defined in ERISA Section 407(d)(3)) maintained by the employer exceeds ten percent of the fair market value of the assets of all pension plans (excluding multi-employer plans) maintained by the employer.


123. "Qualifying employer securities" generally include company stock publicly traded on a national exchange or other generally recognized market. 29 U.S.C. § 1107(d)(5).


127. See infra Part II.B.1.e.


129. See supra note 52.

130. Id.

131. See Fink v. Nat'l Sav. & Trust Co., 772 F.2d 951, 955–56 (D.C. Cir. 1985) ("The investment decisions of a profit sharing plan's fiduciary are subject to the closest scrutiny under the prudent person rule, in spite of the 'strong policy and preference in favor of investment in employer stock.'" (internal citations omitted)); Eaves, 587 F.2d at 459–60.

132. The Pension Benefit Guaranty Corporation provides insurance for retirement plan benefits only for defined benefit plans, not 401(k) plans. A.B.A. EMPLOYEE BENEFITS COMM., supra note 12, at 362–63. This government insurance program is contained in Title IV of ERISA. Id. at 364.
Policy Analysis: Employer's Duty of Prudence in Selecting Company Stock as an Investment Option—The same list of questions presented after the first hypothetical generally are applicable to the second hypothetical. Seeking outside expertise becomes easier to resolve. Obviously, the employer is qualified to evaluate the substantive merits of including its own stock as an investment option. Because the company stock must be publicly traded, the need to make policy distinctions based upon employer size is reduced.

Rate of return, volatility, and liquidity concerns become more prominent in the context of company stock. Employers who have recently “gone public” have no basis on which to evaluate these factors. Liquidity in particular becomes a concern in the event that a company is “delisted” from a national exchange or other market system for failure to meet market capitalization standards.

Diversification technically cannot be considered when the employer selects its own stock as an investment option. It is difficult, however, to ignore the growing number of studies of participant investment choices in 401(k) plans, which indicate that when company stock is offered as an investment option participants tend to invest most heavily in company stock, over other more broad-based investments in the equity markets.

Finally, given the absence of government insurance in the event of employer insolvency, a periodic review of continued suitability becomes more important for the protection of plan participants. Unfortunately, such protection also becomes more difficult. As a practical matter, the employer’s stock is likely to become “unsuitable” only if the company is in financial distress. Until this material information becomes public, however, the employer’s conduct concerning company stock held in the 401(k) plan (and disclosure of information to its own employees) is constrained by federal securities laws.

for many employees to minimize their investment losses from their company stock holdings in the 401(k) plan. Assuming an efficient equities market, the value of the stock will almost instantaneously have plummeted, and along with it, the value of the participant’s retirement benefit.\textsuperscript{140}

2. The Employer’s Duty of Loyalty in Selecting 401(k) Plan Investment Options

a. Established Legal Standards—ERISA section 404(a)(1)(A) requires an employer to “discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan.”\textsuperscript{141} Lawmakers intended the federal courts to interpret this standard, like the duty of prudence, in light of the policy purposes of retirement plans.\textsuperscript{142}

The federal courts generally have viewed this standard as incorporating the common law duty of undivided loyalty expected of trustees under the common law of trusts.\textsuperscript{143} As one leading treatise states, “[d]ealing with the plan assets in order to further one’s own interests rather than those of the plan clearly violates the ... rule.”\textsuperscript{144} Like the duty of prudence, however, the duty of loyalty invokes some degree of flexibility, and thus, judicial discretion, in application. Although an employer must discharge its fiduciary duties “with an eye single to the interests of the participants and beneficiaries,”\textsuperscript{145} some federal courts have ruled that an employer’s actions may also provide benefit “incidentally” to itself.\textsuperscript{146} This incidental benefit to an employer is not necessarily a breach of the duty of loyalty if the employer has conducted a prudent inquiry and has determined reasonably that its decision is in the best in-

\begin{footnotesize}
\begin{enumerate}
  \item The Securities and Exchange Commission’s recent fair disclosure regulation, effective October 29, 2000, is designed to eliminate the practice of selective disclosure and, thereby, level the playing field between individual and institutional investors. Regulation FD (fair disclosure) is likely to reduce the informational advantage that securities analysts and institutional investors who trade in large blocks of a company’s stock previously have enjoyed over individual 401(k) plan investors. Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,716 (Aug. 24, 2000) (to be codified at 17 C.F.R. pts. 240, 243, 249), available at http://www.sec.gov (last visited May 7, 2001).
  \item See supra note 58.
  \item E.g., Leigh v. Engle, 727 F.2d 113, 122-23 (7th Cir. 1984); Eaves v. Penn, 587 F.2d 453, 457 (10th Cir. 1978); Freund v. Marshall & Ilsley Bank, 485 F. Supp. 629, 639 (W.D. Wis. 1979).
  \item A.B.A. EMPLOYEE BENEFITS COMM., supra note 12, at 273.
  \item Donovan v. Bierwirth, 680 F.2d 263, 271 (2d Cir. 1982).
\end{enumerate}
\end{footnotesize}
terests of plan participants. Thus, even though the employer’s duty of prudence technically is separate from the employer’s duty of loyalty, an employer’s lack of prudence may also be a factor in determining whether a breach of the duty of loyalty occurred.

b. Policy Choices: The Incidental Benefit Question—In the 401(k) plan setting, multiple scenarios raise potential duty of loyalty issues. Again, these scenarios arise when the employer selects the investment options for the 401(k) plan. Under each, the policy dilemma for the federal courts will be to draw a line separating permitted “incidental” employer benefits from prohibited self-dealing. This third set of policy choices is the “incidental benefit question.”

The duty of loyalty scenarios discussed below distinguish between general and specialized situations. Thus, the first generation of 401(k) plan litigation currently before the federal courts involves very large employers, with equally large public allegations of employer self-dealing using 401(k) plan assets. Although these cases garnered attention in the financial press, they involve a relatively narrow population of employers and a specialized set of facts.

Less noticed, but potentially much more significant from the perspective of national retirement policy, is the subtle abuse of 401(k) plan assets that every employer, large or small, can engage in when selecting investment options for its 401(k) plan. This abuse occurs when the employer attempts to reduce its cost of 401(k) plan sponsorship by allowing the service provider to charge higher fees and expenses to the participants in the 401(k) plan as a quid pro quo for lower administrative fees charged to the employer.

If left unchallenged, this subtle abuse is likely to have a major impact on the retirement income security of millions of 401(k) plan participants. The Department of Labor actively campaigns against this practice by sensitizing both employers and employees to the issue. In the discussion of duty of loyalty scenarios below, this subtle abuse scenario is presented first because of its


148. See supra notes 7–8.

149. See infra Part II.B.2.c.

150. See supra note 45.
widespread and significant implications for national retirement policy. More specialized litigation scenarios follow.

c. Policy Analysis: The Fees for Costs Loyalty Scenario—The third hypothetical introduces the incidental benefit question that potentially arises when any employer selects investment options for its 401(k) plan.

THIRD HYPOTHETICAL

Employer decides to establish a participant directed 401(k) plan. Employer approaches two Full Service Providers of 401(k) plans. Each Full Service Provider offers a convenient 401(k) plan “package” consisting of all necessary plan documents, administrative services, and plan investment options.

There are two possibilities:

First, Full Service Provider, a Bank, offers its own proprietary mutual funds as 401(k) plan investment options. The Bank’s mutual funds charge a “load” fee (sales commission) of 2.0% to the plan participants. In addition, the Bank’s mutual funds have an annual management fee (paid to the Bank’s sister corporation) equivalent to 2.0% of fund assets. If the Employer’s 401(k) plan uses only the Bank’s mutual funds as its investment options, the Bank will charge the Employer an annual fee of $500 for plan administrative services.

Second, Full Service Provider, a Brokerage Company, offers a wide variety of mutual funds offered by a number of national mutual fund companies as potential investment options for the Employer’s 401(k) plan. These funds vary in the load and management fees they charge. Many of these options carry no load fee and deduct an annual management fee equivalent to 1.0% of fund assets. The Brokerage Company allied itself with an outside vendor who provides plan administrative services for 401(k) plan customers of the Brokerage Company. The Brokerage Company will charge the Employer an annual fee of $2,500 for plan administrative services.

The Employer selects the 401(k) plan package offered by the Bank. The question presented to the federal court is whether Employer has satisfied its fiduciary duty of loyalty in selecting the Bank’s proprietary mutual funds as the investment options for the 401(k) plan.
The policy issue implicit in the third hypothetical is the *incidental benefit* question. Has the employer received a permissible incidental benefit of lower plan costs by selecting the higher-fee service provider, or has the employer breached its duty of loyalty by failing to act solely in the interests of the plan's participants? The answer to this question will have a significant impact on the retirement benefits received by the 401(k) plan participants.

Fees and expenses charged to 401(k) plan participants over time can erode dramatically the value of their retirement benefits. The Department of Labor furnishes the following example of the corrosive effect of plan fees and expenses:

Assume that you are an employee with 35 years until retirement and a current 401(k) account balance of $25,000. If returns on investments in your account over the next 35 years average 7 percent and fees and expenses reduce your average returns by 0.5 percent, your account balance will grow to $227,000 at retirement, even if there are no further contributions to your account. If fees and expenses are 1.5 percent, however, your account balance will grow to only $163,000. The 1 percent difference in fees and expenses would reduce your account balance at retirement by 28 percent.\(^\text{151}\)

The Department of Labor made abusive fee practices by 401(k) plan service providers a national investigative priority for 2000.\(^\text{152}\) This enforcement priority, however, was aimed at the egregious fee practices of plan service providers, not of employers.\(^\text{153}\)

The Department of Labor's 1998 study of 401(k) plan fees and expenses found that service providers routinely offer below cost plan administrative services to employers in exchange for higher asset management fees\(^\text{154}\) that are usually charged to the plan's participants.\(^\text{155}\) The growing trend toward shifting the costs of plan sponsorship to participants means that the incidental benefit question will likely grow in importance in the future.\(^\text{156}\)

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151. *PENSION & WELFARE BENEFITS ADMIN.*, supra note 45, § 1.
153. See supra note 152.
154. *PENSION & WELFARE BENEFITS ADMIN.*, supra note 37, § 3.3.1-2.
155. Id. §§ 1, 3.6, 5.3.2.
156. See id. § 3.7 ("ERISA charges . . . plan sponsors with a fiduciary responsibility to act in the best interests of the plan participants. This implies that plan sponsors will know the costs of the services they procure and will apply due diligence to minimize these costs in the light of the level of services desired.").
The incidental benefit question in the plan fees and expenses context intersects the more profound policy dilemma of employer burden versus participant protection. Here again, the federal courts should be aware of the distinctions between large and small employers. Large employers controlling 401(k) plans with sizable assets have market bargaining power. Service providers compete fiercely for their business and are willing to discount fees and expenses accordingly. Small employers with 401(k) plans of comparably small asset size lack such bargaining leverage. They tend to be limited in their investment options to so-called "retail mutual funds," which have the highest investment management fees.

The technical evidentiary burden presented by the incidental benefit question is how to ascertain the motives of an employer who selects a higher fee service provider. Absent the proverbial smoking gun, evidence of an employer's motives will necessarily be circumstantial and will most likely overlap with evidence of the employer's procedural and substantive prudence.

The employer's procedural prudence involves questions regarding its decisionmaking process, and perhaps most importantly, documentation of that process. How many service providers did the employer consider, and did the employer attempt a comparative analysis of their fees and expenses? In the past, requiring this type of comparative analysis arguably could have imposed an undue burden on employers. Today, the potential for a chilling effect on plan sponsorship is much less likely because the Department of Labor has issued a series of questions and a standardized form for employers to use in comparing the fees and expenses of potential plan service providers, developed with various representatives of the service provider industry. Consequently, a service provider's refusal to cooperate in supplying this information in itself should be a red flag to the employer.

157. Id. §§ 3.5.1, IV; Schultz & Brown, supra note 8.
158. Pension & Welfare Benefits Admin., supra note 37, §§ 2.4.1.3, IV.
159. Id. §§ 3.7 ("smaller plans do not benefit from this price competition"), IV.
160. Id. § 2.4.1.1–3.
161. See supra Part II.B.1.a.
162. See supra notes 60–68 and accompanying text.
163. See supra notes 101–02 and accompanying text.
Stock Market Volatility

Paperwork alone, however, cannot be relied upon as conclusive proof of the employer's loyal motives in selecting the investment options for its 401(k) plan. There must be some objective way to evaluate the substantive prudence of the employer's decision, otherwise the employer's duty of loyalty can be too easily circumvented by the subterfuge of savvy documentation.

The employer's substantive prudence can be evaluated by comparing the plan's fees and expenses with the published industry averages for 401(k) plans of similarly sized assets and participant numbers. This industry measure of substantive prudence should be tempered, however, by a qualitative examination of the services being provided by the employer's selected provider. Cheaper is not always better.

Ultimately, where do these competing policy considerations lead the federal courts who must deal with the incidental benefit question? Employers naturally would prefer a bright line test that promotes certainty in determining their fiduciary responsibilities. Such a bright line rule, however, is likely to prove rigid and inflexible. In the alternative, a flexible multi-factor test based on the facts and circumstances will create uncertainty for employers, but is likely to lead to better policy.

The 401(k) plan services industry is highly competitive. A multi-factor test will focus this competition and, consequently, promote lower fees and expenses. In contrast, a bright line rule proclaiming that a specified amount or formula for fees and expenses is "prudent" may codify today's historically high levels of 401(k) plan fees and expenses. Perhaps more importantly, experts in the employee benefits community are just beginning to examine what constitutes prudent practice for employers who sponsor 401(k) plans. For example, some employee benefits experts suggest that employers develop and use an investment policy to guide their selection and monitoring of 401(k) plan investment options. Few employers currently have investment policies for their 401(k) plans. In ten years, however, such an investment policy may have evolved into a norm for employer prudence. A multi-factor test would encourage this evolution. When the law is uncertain, employers (and the ERISA experts who counsel them)

167. See supra notes 110–11 and accompanying text.
169. See Bogle, supra note 109.
170. Banham, supra note 8, at 75; Carolyn Hirschman, 401(k)s Need Investment Policies, Too, HR Magazine, Oct. 1, 1999, at 100.
171. Hirschman, supra note 170.
naturally tend to err on the side of caution. Such caution is likely to inure to the greater protection of 401(k) plan participants.

d. Policy Analysis: The Shop Only at the Company Store Loyalty Scenario—The "shop only at the company store" scenario is limited to employers who are themselves service providers to 401(k) plans. The fourth hypothetical below illustrates a typical fact pattern.

FOURTH HYPOTHETICAL

Employer is a Full Service Provider with its own line of proprietary mutual funds. Employer acquires another company, which becomes a Subsidiary of Employer. Employer merges the pre-existing 401(k) plan of the Subsidiary into Employer's 401(k) plan. Employer substitutes its own proprietary mutual funds for the investment options previously offered under the Subsidiary's 401(k) plan. The question presented to the federal court is whether the Employer has satisfied its fiduciary duty of loyalty in selecting its own line of proprietary mutual funds as investment options for the 401(k) plan.

The practice by employers in the financial services industry of using their own mutual funds for the retirement plans of their employees predates ERISA. After ERISA was enacted, it appeared that this practice violated ERISA's prohibited transaction rules. Responding to industry requests, in 1977, the Department of Labor issued an administrative exemption that allowed this practice to continue free of ERISA's prohibited transaction rules. As a result, this practice continues to be widespread among employers in the financial services industry.

With respect to ERISA's fiduciary responsibility provisions, however, the Department of Labor's position is that the prohibited

173. Id.
transaction exemption does not exempt an employer from its fiduciary duties under ERISA section 404(a). The first generation of 401(k) plan fiduciary litigation has produced two types of factual allegations involving an employer's breach of the duty of loyalty. The first type of allegation involves a service provider who charges higher 401(k) plan fees and expenses to its own employees than to its 401(k) plan customers. The second type of allegation involves a service provider who has, by industry standards, a relatively small amount of investment assets under management. To make its investment vehicles more attractive to large institutional players in the retirement plan market, the service provider needs to increase the size of its investment assets under management. By limiting employee 401(k) investment options to the service provider's proprietary investment vehicles, the service provider can quickly increase the size of its investment products and, in the process, attract business from outside investors.

Both types of factual allegations squarely raise the incidental benefit question. Again, the difficult evidentiary issue is to ascertain the employer's motives in selecting its own products as investment options for its employees' 401(k) plan. Here, a useful objective standard to add to the multi-factor test suggested previously is to compare the employer's practices with those of other service providers in the industry. The focus of this comparison should not be whether the employer has conformed to the industry's lowest common denominator. This approach will only

177. See generally Demby, supra note 8 (discussing allegations that First Union Corporation violated its fiduciary duty in handling pension plan assets associated with its acquisition of Signet Bank); England, supra note 8 (same). The bulk of these fees are attributable to investment management fees generated when the service provider's employees invest their 401(k) plan money in the employer's proprietary investment vehicles, which in turn generate income for the service provider. Demby, supra note 8.
178. See generally Demby, supra note 8 (discussing allegations that First Union Corporation violated its fiduciary duty in handling pension plan assets associated with its acquisition of Signet Bank); England, supra note 8 (same).
179. See Demby, supra note 8, at 74.
180. See id.
181. See supra Part II.B.2.c.
182. The practices of other leading service providers in the industry indicate that a higher standard of loyalty to the employer's own employees certainly is possible. For example, Vanguard offers only its own mutual funds as investment options for its own employees' 401(k) plan, but offers these funds "at cost." Jacobius, Service Providers, supra note 175. Merrill Lynch offers sixty-four investment options to its employees, of which six are outside (non-proprietary) funds. Id.
fossilize low industry standards. Rather, the federal courts should focus on those service providers whose practices in administering 401(k) plans for their own employees are the most favorable, in terms of fees, expenses, and investment option flexibility, to their employees. Such an approach is likely to provide greater insight into the employer's motives. It forces the employer to articulate and justify why it cannot adopt the same favorable practices as its competitors in the industry. In the long run, this inquiry will promote the evolution of more effective fiduciary standards for those 401(k) plan participants who must shop only at the company store.

e. Policy Analysis: Company Stock Loyalty Scenarios in Mergers and Acquisitions—Company stock scenarios involve publicly traded companies who include their own stock as an investment option in their 401(k) plans. There are numerous scenarios in which company stock held in a 401(k) plan could generate claims that the employer has breached its duty of loyalty. Company stock held in a 401(k) plan sets the stage for potential conflicts of interest between the employer's corporate fiduciary duty to its shareholders and its ERISA fiduciary duty to 401(k) plan participants. Inclusion of company stock as an investment option creates the potential for undue influence by the employer when participants' votes are weighted according to their ownership of company stock. These voting matters may include corporate governance, such as the election of directors, or the approval of tender offers or mergers. Finally, the inclusion of company stock in the employer's 401(k) plan can raise incidental benefit questions. The fifth hypothetical below presents an example in which these considerations become intertwined. 183

FIFTH HYPOTHETICAL

Employer A sponsors a 401(k) plan that includes Employer A's company stock as an investment option. Employer A spins off one of its subsidiary companies into a new public company, Company C. As a result, participants in the Employer A 401(k) plan who originally held Employer A company stock now also hold stock of Company C.

183. Although on the surface this hypothetical may appear to be unrealistic, it is not. The fifth hypothetical is loosely based on the plaintiffs' allegations in Gottlieb v. SBC Communications, Inc., No. CV-00-04139, AHM(MANx) (C.D. Cal. filed April 18, 2000, amended Nov. 6, 2000), available at http://www.airtouchsuit.com (last visited Mar. 31, 2001).
Later, Employer A merges into Employer B. The Employer A’s 401(k) plan is merged into Employer B’s 401(k) plan. Employer B’s 401(k) plan has Employer B company stock as an investment option. Company C is a direct competitor of Employer B. Employer B liquidates the Company C stock holdings of the former Employer A 401(k) plan participants, and invests the proceeds in company stock of their new Employer B.

Employer B justifies the liquidation of the Company C stock on the ground that its 401(k) plan should not encourage its employees to promote the success of a business competitor. Shareholders (and analysts) of Employer B are delighted when the share price of the Employer B company stock receives a boost as a result of the large purchase by the Employer B 401(k) plan. High-level corporate officers whose compensation is based in part on the stock price of Employer B also benefit. Two years later, the share price of the Employer B company stock has failed to increase further in value. Meanwhile, the shares of Company C stock have tripled in value.

The question presented to the federal court is whether Employer B has breached its duty of loyalty to those participants whose Company C stock was liquidated and replaced with the company stock of Employer B.\(^{184}\)

Resolving duty of loyalty cases that involved company stock necessarily will turn on the unique facts of each case. The purpose here is not to provide a global solution to these types of cases, but rather, to identify the three approaches the federal courts may adopt to resolve these cases and discuss their underlying policy implications.

The first (and most drastic) approach is for the federal courts to rule that employer decisions concerning company stock, even company stock held in a 401(k) plan, are a protected settlor function under ERISA.\(^ {185}\) The settlor function doctrine is a judicially

\(^{184}\) The duty of loyalty question in the fifth hypothetical is triggered by a corporate merger. Despite the fact that mergers and acquisitions are common, the ERISA fiduciary duties of corporate employers in these situations are unclear. England, supra note 8, at 70. ERISA section 208 requires only that after a plan merger, “each participant in the plan would (if the plan then terminated) receive a benefit immediately after the merger, consolidation, or transfer [of plan assets] which is equal to or greater than the benefit he would have been entitled to receive immediately before the merger, consolidation, or transfer (if the plan had then terminated).” 29 U.S.C. § 1058 (1994). This provision also is part of the statutory requirements for qualified plans. I.R.C. § 414(l) (1994); see also A.B.A. EMPLOYEE BENEFITS COMM., supra note 12, at 175–78 (describing how the merger rule works in practice).

\(^{185}\) In most corporate mergers or acquisitions, the separate 401(k) plans of the combining corporate entities also must be merged to satisfy the minimum coverage
created exception to the employer’s fiduciary responsibilities under ERISA.\textsuperscript{186} The doctrine attempts to draw a sharp line between actions taken in an employer’s corporate capacity and actions taken in its fiduciary capacity. In a nutshell, the doctrine says that employer “business” decisions, including decisions involving the establishment, amendment, merger, or termination of employee benefit plans are made in the employer’s capacity as “settlor” of the plan and, therefore, are not subject to ERISA’s fiduciary duty provisions.\textsuperscript{187}

In recent years, the Supreme Court has issued several decisions construing the scope of the settlor function doctrine.\textsuperscript{188} The doctrine has yet to be applied, however, to employer decisions concerning company stock held in a 401(k) plan, nor should it be in the future. The settlor function approach is flawed. Although the settlor function doctrine attempts to distinguish business decisions made by the employer, as the fifth hypothetical illustrates, such decisions in the 401(k) plan context quickly cross over into core ERISA fiduciary functions as defined by the statute.

ERISA defines a fiduciary as anyone who “exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets.”\textsuperscript{189} This statutory definition must be considered in light of the Department of Labor’s interpretation that the selection of 401(k) plan investment options is a fiduciary function.\textsuperscript{190} Referring back to the facts of the fifth hypothetical, the federal courts could attempt to split some fine legal hairs by drawing a distinction between the removal of the Company C stock as an investment option and the selection of the Employer B company stock as a replacement. Under this hair-splitting approach, a federal court will view the removal of the Company C stock as falling within the scope of the settlor function, characterizing it as part of the termination and merger of the Employer A 401(k) plan. Employer B’s selection of its own company

\textsuperscript{188} See supra note 187.
\textsuperscript{190} See supra note 70 and accompanying text.
stock will, however, under the Department of Labor's interpretation, still be reviewed by the federal courts as a fiduciary act of Employer B. If a federal court severs these two decisions concerning the 401(k) plan assets and analyzes them independently, Employer B can more easily justify its decision to include its own company stock as an investment option in the 401(k) plan.

From a policy perspective, the settlor function approach to company stock scenarios clearly negates the employer's duty of loyalty in the circumstances in which it is most needed. In the fifth hypothetical, Employer B's decision to limit the investment options in the 401(k) plan to Employer B's company stock appears benign when viewed in isolation. Viewed in the context of the entire transaction, however, Employer B's decision appears to be tainted by numerous conflicts of interest. A federal court ruling that Employer B's conduct is protected from judicial scrutiny as a settlor function will be an open invitation to employer self-dealing and abuse of 401(k) plan assets invested in company stock.

A second approach is for the federal courts to rely on evidence of procedural prudence in determining whether an employer has satisfied its fiduciary duty of loyalty. An expansive interpretation of what constitutes a permitted incidental benefit to the corporate employer may be coupled with this approach. This is the "formalistic approach."

The formalistic approach has several practical policy implications. A strong and early signal to the employee benefits community that the federal courts will rely heavily on procedural prudence will lead to immediate conforming behavior by employers. Policies directing the treatment of 401(k) plans holding company stock in mergers or acquisition situations will spring forth overnight from experts in the employee benefits community. These same experts will counsel employers to eliminate the appearance of conflicts of interest by eliminating any overlap between those persons who serve on the corporation's board of directors and the individuals who form the 401(k) plan's administrative committee. Meticulous documentation of fiduciary decisions affecting 401(k) plans in merger and acquisition situations will occur. Perhaps most practical of all, if the federal courts adopt a formalistic approach to these cases, summary judgments based on procedures and related employer documentation will be made more feasible and more likely to be upheld upon appeal.

Skeptics will argue that excessive reliance on the formalistic approach is inconsistent with ERISA's policy of protecting plan participants. After all, clever ERISA experts can advise employers
how to meet the facial standards for procedural prudence, and
document virtually any employer decision. These skeptics are
right. Sole reliance on a formalistic approach will effectively
amend the employer’s statutory duty of loyalty. It will dramatically
lower the traditionally high standard of judicial scrutiny for fiduci-
ary conflicts of interests to a de facto “arbitrary and capricious”
level of judicial review.

The proper approach for the federal courts to use in cases in-
volving company stock is to engage in a probing analysis of the
employer’s decisions consistent with judicial precedent interpret-
ing the employer’s duty of loyalty. The employer’s apparent
procedural prudence will then be only one factor in determining
whether the duty of loyalty has been satisfied. This is the
“fiduciary scrutiny” approach.

The fiduciary scrutiny approach has several beneficial policy ef-
fects. First, experts in the employee benefits community will be
more likely to counsel employers to avoid future potential prob-
lems by not including company stock as an investment option in
newly established 401(k) plans. Such cautious advice will deter the
practice and thereby reduce the accompanying risk of large in-
vestment losses by 401(k) plan participants. Second, employers
who already have 401(k) plans with company stock as an invest-
ment option will be likely to err on the side of non-interference
with company stock in merger and acquisitions situations. If the
acquiring employer decides that a change must be made that af-
facts the acquired employer’s company stock held in a 401(k)
plan, the acquiring employer will be more likely to make greater
options available to those 401(k) plan participants. In addition, a
more complete and thorough disclosure of these options by the
acquiring employer is likely to occur. Such improved disclosures

191. See supra note 95.
the district court erred in applying deferential arbitrary and capricious standard to em-
ployer’s duty of prudence and that the appropriate judicial standard as required by the
statute is “prudence under the circumstances”).
193. See supra Part II.B.2.a.
194. See supra note 147 and accompanying text.
195. One potential policy concern that is unlikely to materialize from a fiduciary scru-
tiny approach is a deterrence effect on merger and acquisition activity. In making these
strategic decisions, federal judges need not be concerned that 401(k) plans will become the
tail that wags the corporate dog. The effect of a merger or acquisition on employee benefit
plans is usually never considered until long after the business details of the deal are final-
ized. England, supra note 8, at 72 (“Merger negotiations seldom attach a high priority to
workers’ nest eggs. Thus, details of pension programs often get short shrift.”).
will enable the 401(k) plan participants to make more informed decisions concerning their 401(k) plan assets.

The costs, in terms of judicial resources, of adopting the fiduciary scrutiny approach will be high. Probing scrutiny is factually intensive and time-consuming for the federal district court judges who must act as the triers of fact.\textsuperscript{197} The fiduciary scrutiny approach also is less conducive to summary judgment disposition.\textsuperscript{198} The judicial cost, however, also carries with it potential benefits for national retirement policy. The fiduciary scrutiny approach is likely to deter company stock loyalty scenarios in mergers and acquisitions. Employers engaged in mergers and acquisitions will be reluctant to engage in conduct that may trigger prolonged and complex ERISA fiduciary litigation. Consequently, the mere threat of time-consuming and costly federal litigation will serve to protect participants from the employer misuse of company stock held in 401(k) plans.

3. The Employer’s Duty of Prudent Diversification and the 404(c) Regulations Defense—It seems paradoxical to speak of the employer’s duty of prudent diversification in the context of a 401(k) plan in which the participants themselves direct the investment of their individual accounts. Nevertheless, the duty of prudent diversification of plan assets remains relevant due to two subtle, yet significant, Department of Labor interpretations of ERISA section 404(c).

First, an initial affirmative investment direction made by the plan participant is required to activate the employer’s liability exemption under section 404(c).\textsuperscript{199} Until this first affirmative investment direction is made, the employer remains responsible for the investment of assets held in the participant’s 401(k) plan account.\textsuperscript{200} It is only after the participant has made an affirmative investment direction that, assuming all of the requirements of the 404(c) Regulations have been met, the employer is not responsible for investment losses resulting from the participant’s investment

\textsuperscript{197} See supra note 12. For an example of the fact-finding task that is likely to face the federal courts under the fiduciary scrutiny approach, see the federal district court’s opinion in \textit{In re Unisys Savings Plan Litigation}, 21 Employee Benefits Cas. (BNA) 2514 (E.D. Pa. 1997).

\textsuperscript{198} See \textit{In re Unisys Sav. Plan Litig.}, 74 F.3d 420, 425 (3d Cir. 1996) (vacating district court’s grant of summary judgment and remanding the case for a bench trial).


\textsuperscript{200} Id.; Medill, supra note 22, at 37 (criticizing this rule as misleading to plan participants in practice).
direction.\textsuperscript{201} This agency interpretation has important consequences for the growing interest among employers in so-called "automatic enrollment" 401(k) plans.\textsuperscript{202}

Second, the Department of Labor interprets the 404(c) Regulations as a defense or statutory exemption to employer conduct that violates the duty of prudent diversification of assets.\textsuperscript{203} Mere non-compliance with the 404(c) Regulations does not, in and of itself, establish a breach of the employer’s duty of prudent diversification of assets.\textsuperscript{204} Therefore, in an action to recover investment losses from the employer, if the employer has not breached any other fiduciary duties, the plan participant must establish a breach by the employer of the duty of prudent diversification of assets. These types of "sore loser" cases and the employer's related defense under 404(c) Regulations\textsuperscript{205} are discussed in Part II.3.b. below.

\textit{a. The Employer’s Duty of Prudent Diversification and the Automatic Enrollment Scenario}—ERISA section 404(a)(1)(c) requires the employer to "diversify... the investments of the plan so as to minimize the risk of large losses, unless, under the circumstances, it is clearly prudent not to do so."\textsuperscript{206} The legislative history explains this duty as follows:

Ordinarily the fiduciary should not invest the whole or an unduly large proportion of the trust property in one type of security or in various types of securities dependent upon the success of one enterprise or upon conditions in one locality, since the effect is to increase the risk of large losses. Thus, although the fiduciary may be authorized to invest in industrial stocks, he should not invest a disproportionate amount of the plan assets in the shares of corporations engaged in a particular industry.\textsuperscript{207}

\textsuperscript{201} Final Rule Regarding Participant Directed Individual Account Plans, 57 Fed. Reg. at 46,923.
\textsuperscript{202} This trend and related policy issues are discussed \textit{infra} in Parts II.B.3.a. and III.B.2.
\textsuperscript{205} 29 C.F.R. § 2550.404c-1.
\textsuperscript{206} 29 U.S.C. § 1104(a)(1)(C).
The federal courts have broad discretion in determining whether a breach of the duty of prudent diversification of plan assets has occurred. There is no fixed formula or percentage that will determine when plan assets are concentrated unduly in a single or similar investment. Instead, the federal courts must consider all of the facts and circumstances.

Cases construing the employer's duty of prudent diversification of plan assets are set in the context of plans directed by trustees responsible for the investment of plan assets. In this setting, the federal courts view the entirety of the plan's investments to determine whether a breach of duty occurred. In contrast, in the 401(k) plan context, the appropriate focus is on each participant's individual account.

Beginning in 1998, the Internal Revenue Service issued a series of revenue rulings that encourage employers who sponsor 401(k) plans to enroll all eligible workers in the plan, deduct a set percentage of employee compensation (typically one to three percent), and contribute that amount to employee 401(k) plans. This type of enrollment arrangement is known as an "automatic enrollment" 401(k) plan.

In a traditional 401(k) plan, the employee must affirmatively enroll as a participant in the plan. Until the enrollment paperwork is completed, the employee may not participate in the 401(k) plan. A convenient way to conceptualize the traditional 401(k) plan is that the plan presumes an employee will not participate, and the employee must affirmatively act to overcome that presumption. Of course, there will be a certain group of workers who will not take action, and, consequently, will not participate in the plan.

Automatic enrollment arrangements attempt to capture this group by reversing the presumption of nonparticipation. An


213. Barnhart, supra note 212; Clinton Urges Automatic Enrollment in Employers' Section 401(k) Plans, DAILY TAX REP., June 5, 1998, at G-9 [hereinafter Clinton Urges Automatic Enrollment].
automatic enrollment plan presumes that every eligible employee will participate. The employer enrolls every eligible employee and puts the burden on the employee to opt out of the plan. The result is a higher rate of employee participation in the 401(k) plan.

From the perspective of national retirement policy, automatic enrollment plans are a positive development because they encourage increased retirement savings. Few employers offer such plans, however. A 1999 survey by Hewitt Associates found that, despite Internal Revenue Service approval, only seven percent of employers have adopted an automatic enrollment for their 401(k) plans. One of the major obstacles to the widespread adoption of automatic enrollment plans is the legal ambiguity surrounding the employer's fiduciary responsibility and potential liability under ERISA. This ambiguity is illustrated by the sixth hypothetical.

SIXTH HYPOTHETICAL

Employer adopts an automatic enrollment 401(k) plan. The plan provides that upon commencement of employment all eligible employees are enrolled as participants in the plan. Employer will deduct and contribute to the plan three percent of each employee's compensation. The employee can "opt out" of participating in the 401(k) plan by completing the necessary paperwork.

The 401(k) plan provides that unless and until the employee elects differently, the employee's contributions to the plan will be invested in a money market mutual fund that earns an investment return of five percent annually. All employees are notified of this "default" investment provision and are encouraged to exercise their right to invest in

214. Barnhart supra note 212.
215. I.R.S. Announcement 2000-60, 2000-31 I.R.B. 149; Clinton Urges Automatic Enrollment, supra note 213; see also PROFIT SHARING/401(k) COUNCIL OF AMERICA, AUTOMATIC ENROLLMENT 2000, at http://www.psca.org (last visited on May 8, 2001) (study of how companies structure their automatic enrollment plans) (on file with author). Survey results indicate that automatic enrollment plans have an employee participation rate of ninety percent or more, compared with a participation rate in traditional 401(k) plans of around seventy percent. See Barnhart, supra note 212.
216. Hewitt Associates, supra note 41. This was an increase from just four percent in 1997. Id.
217. See Barnhart, supra note 212. Another legal obstacle to the widespread adoption of automatic enrollment plans is the uncertainty as to whether this type of arrangement violates state laws governing employee payroll deductions and, if so, whether such state laws are nonetheless preempted by ERISA. A discussion of this issue is beyond the scope of this Article.
the diversified range of investment options available to participants in the 401(k) plan.

In 1998, Employee A is automatically enrolled in the 401(k) plan upon commencement of her employment. Employee A never opts out of the 401(k) plan and fails to exercise her right to select the investment options for her contributions automatically made to the plan. As a result, her contributions are invested in the plan’s default option, the money market mutual fund.

In 2005, Employee A is ready to retire. Her 401(k) plan account has experienced investment earnings from the money market fund equal to fifty percent of her total contributions. Employee A is upset when she learns that if her 401(k) contributions had been invested instead in one or a combination of the plan’s equity-based mutual funds, her retirement benefit from the 401(k) plan would have been three hundred percent more due to the greater investment returns.

Employee A sues Employer for breach of its fiduciary duty of prudent diversification. The question presented to the federal court is whether the Employer is liable under ERISA for the “lost” investment gains Employee A did not receive because her contributions were invested in the plan’s default money market fund instead of an equity-based mutual fund or funds.

The sixth hypothetical raises three novel issues for resolution by the federal courts. These issues involve interpretation of the 404(c) Regulations, the employer’s fiduciary duty of prudent diversification of plan assets, and ERISA’s remedy provisions.

The first issue raised by the sixth hypothetical is whether Employee A made an affirmative investment direction sufficient to trigger the 404(c) Regulations. If so, Employer may assert as a defense exemption from fiduciary liability under the 404(c) Regulations. The historical development of the 404(c) Regulations suggests how the federal courts should approach this issue. When the Department of Labor first proposed the 404(c) Regulations in 1987, the agency initially extended the liability exemption of ERISA section 404(c) to employers in situations in which the participant had not made an affirmative investment direction.\(^\text{218}\) To qualify for this protection, the employer had to satisfy several conditions, but primarily the participant’s account had to be invested

in one of two possible "safe" default investment options. 219 These two safe default options were an interest-bearing bank deposit account or a money market mutual fund. 220 Commentators on the 1987 draft asked that this provision be deleted from the 404(c) Regulations, in part because "sponsors would rather retain fiduciary responsibility for contributions as to which participants and beneficiaries have not submitted instructions than avail themselves of the relief described in the proposal." 221 In addition, "the comments and the statistical evidence submitted indicated that very few plans providing for direction by participants and beneficiaries offered the vehicles specified, and that for plans which did, a negligible amount of plan assets directed into such options." 222 In other words, employer protection in default investment situations was unnecessary.

The next version of the 404(c) Regulations, issued in 1991, omitted the default investment option provision. 223 By this time, commentators on the regulations were having second thoughts, and requested that the Department of Labor reinstate a default investment provision extending relief from liability to employers where the participant failed to make an affirmative investment direction. 224 The Department of Labor considered this suggestion and expressly rejected it in the final 404(c) Regulations in 1992. 225 The agency emphasized its position that the employer would remain responsible for investment decisions unless or until an affirmative investment direction was made by the participant. 226

The Department of Labor's official interpretation of the final 404(c) Regulations provides some guidance concerning the meaning of an affirmative investment direction. Merely disclosing to participants in the summary plan description where their 401(k) plan money will be invested if they fail to provide investment directions is insufficient to rise to the level of an affirmative investment direction. 227 Under this interpretation, mere inaction by the participant can never rise to the level of an affirmative investment direction, no matter how well-informed the participant may be concerning the consequences of his failure to act. In contrast, if

219. Id.
220. Id.
222. Id.
223. Id.
224. See id.
225. Id.
226. See id.
227. Id. at 46,924.
the participant "signs an instruction form specifying how assets in his account will be invested" in the absence of his affirmative direction, this act of written consent can operate as an affirmative investment direction.\footnote{228} The circumstances surrounding this written consent, however, must indicate that the participant's consent was both informed and voluntary.\footnote{229}

In the sixth hypothetical, Employee A never gave her written consent to Employer's default investment option. Therefore, a federal court hearing this type of case must go on to address two more issues. These issues concern the statutory interpretation of ERISA's fiduciary duty and remedy provisions.

Even though the 404(c) Regulations are not available as a defense to the Employer, to prevail on her claim, Employee A must still establish that investing her contributions in the money market fund was a breach of the Employer's duty of prudent diversification of plan assets under ERISA section 404(a) (1) (c).\footnote{230} The statutory language of section 404(a) (1) (c) raises two interpretive issues. First, did Employer fail to diversify the account by investing the 401(k) plan assets in a safe, but low-earning, money market fund?\footnote{231} If so, was Employer's decision to invest all of the account in the money market fund nevertheless prudent under the circumstances? Here the sixth hypothetical highlights the ambiguity in the statutory description of Employer's duty of prudent diversification of plan assets. In the hypothetical, Employer's default investment option, a money market fund, minimizes the risk of a loss of principal. It should be noted, though, that at least one federal court has interpreted section 404(a) (1) (c) expansively, ruling that the duty of prudent diversification of plan assets is not strictly limited to a loss of principal but may apply to other types of risk as well.\footnote{232}

From a policy perspective, a federal court's task in interpreting the statutory language is difficult because at the time the statute

\footnotesize{\begin{itemize}
\item \textit{Id.}
\item \textit{Id.}
\item The plan participant bears the initial burden of proving that the fiduciary responsible for investing the plan's assets failed to diversify the investments. \textit{See} Metzler v. Graham, 112 F.3d 207, 209 (5th Cir. 1997); \textit{In re} Unisys Sav. Plan Litig., 74 F.3d 421, 438-40 (3d Cir. 1996); H.R. \textit{CONF. REP.} No. 93-1280, at 304 (1974), \textit{reprinted in} 1974 U.S.C.C.A.N. 5038, 5084. Once this initial burden of proof has been satisfied, the burden then shifts to the fiduciary to prove that their investment decisions were prudent under the circumstances. \textit{See} H.R. \textit{CONF. REP.} No. 93-1280, at 304, \textit{reprinted in} 1974 U.S.C.C.A.N. at 5084.
\item \textit{See} Barnhart, \textit{supra} note 212 (finding that eighty percent of 401(k) plan accounts automatically enrolled by the employer are invested in low-yielding money market funds).
\end{itemize}}
was drafted, the 401(k) plan did not exist. As a result, the statutory interpretation approach that relies on "plain meaning" becomes inherently unreliable. As instructed by Congress, the federal courts must seek to interpret the statutory language "bearing in mind the special nature and purpose" of 401(k) plans.238

ERISA section 404(a)(1)(c) was written with a different type of retirement plan in mind: the traditional defined benefit plan in which the employer is responsible for investing the plan's assets.234 In this type of plan, the amount of the participant's eventual retirement benefits is not dependent on plan investment earnings. If the plan's assets lose money, the employer remains financially responsible so that the participants will receive their promised levels of benefits.235 In the event the employer is unable to pay the promised benefits, the benefits are federally insured by the Pension Benefit Guaranty Corporation (PBGC).236 In this context, the employer's fiduciary duty to diversify and thereby avoid the "risk of large losses" is sound policy. It preempts the type of catastrophic losses that would undermine both the employer's ability to pay and, ultimately, the fiscal soundness of the PBGC insurance program.

The retirement benefits under a 401(k) plan are fundamentally different. In a 401(k) plan, the participant's retirement benefit consists of the amount in her 401(k) plan account at retirement, usually paid as a lump sum.237 In the 401(k) plan context, the risk of loss is amenable to at least three possible judicial interpretations. Loss can be defined as a loss of principal, an inflationary loss, or an opportunity loss.

The difference between a loss of principal and an inflationary loss is illustrated by the following example. Assume that the Employer in the sixth hypothetical had automatically deducted $500 each month from Employee A's paycheck and contributed this amount to her 401(k) plan account. After twenty years, Employee A would have accumulated $120,000 in retirement savings attributable solely to contributions. For simplicity of illustration, assume that these contributions had been secured in a bank vault, in cash, for those twenty years. Employee A has not "lost" one penny on her principal amount of $120,000 as an accountant would define the term, but in an economic sense, Employee A suffered a very

234. Langbein & Wolk, supra note 19, at 45–46, 50–54.
235. Id.
236. See supra note 132 and accompanying text.
237. Reforming ERISA, supra note 52.
real injury. Inflation over those twenty years eroded greatly the purchasing power of her $120,000, creating an inflationary loss.

From the perspective of national retirement policy, investing 401(k) plan contributions in a money market fund does little to enhance the retirement income security of the plan participants. The minimal earnings of the money market fund may provide some protection against inflationary loss in periods of relatively low inflation. But in a money market investment situation, the 401(k) plan participants suffer another type of loss—they have forgone the greater investment returns produced by a diversified portfolio invested prudently and broadly over the long term in the equity markets. This forfeiture of greater investment returns is an opportunity loss.

A final consideration in the interpretation of the duty of prudent diversification of plan assets is the employer's likely motivation for selecting the money market fund as the default investment option. Given the certain opportunity loss, such an investment is of dubious prudence. Then, why do employers do it? Employers fear the potential fiduciary liability for a loss of principal. If the participant's contributions are invested in a money market fund, the risk of a loss of principal is eliminated. Absent this fear, employers in general would be willing to select a more volatile, but in the long run, more rewarding, default investment option for their automatic enrollment 401(k) plans. Part III demonstrates how, through interpretation of ERISA's remedy provisions, the federal courts can encourage employers to select default investment options that minimize the risk of opportunity losses for the employees who are enrolled automatically in 401(k) plans.

b. The Sore Loser Scenario—It should be evident that the 404(c) Regulations will be available as an employer defense in ERISA fiduciary litigation only in a narrow category of cases. The employer cannot assert the 404(c) Regulations as a defense to an alleged breach of the duty of prudence nor the duty of loyalty. In addition, the defense is not available where the participant never affirmatively directed the investment of her 401(k) plan account.

The narrow category of cases where the 404(c) Regulations are available as an employer defense are the “sore loser” cases. The sore loser scenario assumes that the participant affirmatively directed the investment of her 401(k) plan account. It further

238. Barnhart, supra note 212.
239. See supra note 70 and accompanying text.
240. See supra notes 200–01 and accompanying text.
assumes that the employer fulfilled its duty of prudence in selecting the plan’s investment options and that there is no allegation that the employer’s decision was tainted by self-interest. With these underlying assumptions in mind, the seventh hypothetical describes a sore loser case.

SEVENTH HYPOTHETICAL

Employer establishes a 401(k) plan. Encouraged by spectacular investment returns in prior years, Employee A invests 100% of her 401(k) plan account in a high technology stock mutual fund.

In 2005, Employee A is ready to retire. She is upset that her retirement benefit from the 401(k) plan is less than the amount of her contributions made to the plan over the years, that is, that her 401(k) plan investment in the high technology stock fund has lost money.

Employee A sues Employer for breach of its fiduciary duty of prudent diversification under ERISA, seeking to recoup her investment losses. The Employer defends by asserting that it complied with the 404(c) Regulations and therefore is not liable for Employee A’s investment losses. The question presented to the federal court is whether Employer has “complied” with the 404(c) Regulations.

The discussion below presents a general overview of the employer’s defense under the 404(c) Regulations. In keeping with the premise of this Article, areas where broad policy-making discretion is conferred upon the federal court are highlighted and discussed.\(^241\) The exercise of this discretion is likely to have a significant and sweeping impact on national retirement policy for the foreseeable future.

(i). The Framework of the Employer’s 404(c) Regulations Defense—There are three basic plan design requirements under the 404(c) Regulations. First, the plan must offer a broad and diversified range of at least three investment options to plan participants (the diversified range rule).\(^242\) The purpose of the diversified range rule is to ensure that participants have the opportunity to avoid the risk of incurring large investment losses by diversifying their account

\(^241\) The reader interested in the technical nuances of the 404(c) Regulations should consult the footnotes accompanying this discussion and the original sources cited therein.

Each investment option must present materially different risk and return characteristics. Other than these criteria, the 404(c) Regulations leave the selection of specific types of investment options up to the fiduciary discretion of the sponsoring employer.

Second, the plan must allow participants to transfer the assets in their account into and out of the various plan investment options with a frequency that is reasonable in light of the market volatility of those investment options (the general volatility rule). At a minimum, the plan participants must be allowed to make transfers among at least three of the investment options not less frequently than every three months (the three-month minimum rule). The underlying purpose of the general volatility and three-month minimum rules, is to allow the plan participants to minimize large investment losses by quickly transferring out of sinking investments. Subject to the three-month minimum rule, the 404(c) Regulations leave the determination of how frequently the participants are allowed to transfer investments up to the fiduciary discretion of the sponsoring employer.

Third, the plan’s investment options must permit participants to actually diversify the investment of their plan accounts (the actual diversification rule). Under the actual diversification rule, the plan’s design must take into account how the small size of participants’ account balances may limit their ability to achieve investment diversification. In particular, if the plan’s investment options are limited to individual stocks or bonds, participants with

244. 29 C.F.R. § 2550.404c-1(b)(3).
245. Earlier drafts of the 404(c) Regulations are more specific concerning the types of investment options offered. These proposed rules were eliminated in the final regulation to preserve employer flexibility. Final Regulation Regarding Participant Directed Individual Account Plans, 57 Fed. Reg. at 46,919–20.
246. 29 C.F.R. § 2550.404c-1(b)(2)(ii)(C). There are two alternative methods for satisfying the general volatility rule. One is to require at least a single core investment option to accept transfers coming in (that is, a transfer out of a volatile investment must be able to go somewhere else) at least as frequently as any volatile investment, where transfers are allowed in excess of every three months. Id. § 2550.404c-1(b)(2)(ii)(C)(2)(i). An alternative method of compliance is to establish a cash-equivalency fund that receives and holds transfers out of a volatile investment until the next transfer period arrives. Id. § 2550.404c-1(b)(2)(ii)(C)(2)(ii).
249. See id.
small account balances will be unable to achieve a diversified account portfolio.\textsuperscript{252} To satisfy the actual diversification rule, the plan can offer "look-through investment vehicles" (for example, mutual funds)\textsuperscript{253} as investment options.\textsuperscript{254} Actual diversification is then determined by looking through to the assets underlying the investment vehicle. It is the actual diversification rule that results in the selection of mutual funds as investment options for almost all 401(k) plans.\textsuperscript{255}

Although company stock is not considered a suitable investment option for purposes of satisfying the diversified range rule, the 404(c) Regulations expressly permit the employer to offer plan participants company stock as an additional investment option.\textsuperscript{256} Certain additional rules apply to plans that offer company stock as an investment option.\textsuperscript{257} The fundamental purpose of these special rules is to ensure that the investment decisions made by the plan participants are truly independent and not subject to undue influence by the employer.\textsuperscript{258}

First, company stock offered as an investment option must be publicly traded.\textsuperscript{259} The purpose of the publicly traded requirement is to ensure that the 401(k) plan participants can buy and sell the company stock in a market that is free from influence by the employer.\textsuperscript{260} Second, the plan must have procedures in place to safeguard the confidentiality of information relating to the purchase, sale, and holding of company stock by participants.\textsuperscript{261} Third, the plan must designate a fiduciary to monitor compliance with

\begin{itemize}
  \item \textsuperscript{252} Final Rule Regarding Participant Directed Individual Account Plans, 57 Fed. Reg. at 46,920-21, 46,921 n.19.
  \item \textsuperscript{253} 29 C.F.R. § 2550.404c-1(e)(1)(i).
  \item \textsuperscript{254} Final Rule Regarding Participant Directed Individual Account Plans, 57 Fed. Reg. at 46,921.
  \item \textsuperscript{255} Recently it has become more common for 401(k) plans to allow participants to invest in individual stocks besides employer securities, or in more volatile sector funds limited to technology or internet stocks. \textit{Employers Should Move with Caution on Internet Stocks}, DEFINED CONTRIBUTION NEWS, Aug. 16, 1999, at 6; Linton, \textit{supra} note 49; Hewitt Associates, \textit{supra} note 41.
  \item \textsuperscript{256} Final Rule Regarding Participant Directed Individual Account Plans, 57 Fed. Reg. at 46,919.
  \item \textsuperscript{257} 29 C.F.R. § 2550.404c-1(d)(2)(ii)(E)(4).
  \item \textsuperscript{258} Final Rule Regarding Participant Directed Individual Account Plans, 57 Fed. Reg. at 46,922.
  \item \textsuperscript{259} 29 C.F.R. § 2550.404c-1(d)(2)(ii)(E)(4)(iii). To satisfy this requirement, the company stock must be traded either on a national exchange or in another generally recognized market. Final Rule Regarding Participant Directed Individual Account Plans, 57 Fed. Reg. at 46,927.
  \item \textsuperscript{260} Final Regulation Regarding Participant Directed Individual Account Plans, 57 Fed. Reg. at 46,927.
  \item \textsuperscript{261} 29 C.F.R. § 2550.404c-1(d)(2)(ii)(E)(4)(vii).
\end{itemize}
these confidentiality procedures.\textsuperscript{262} This designated monitoring fiduciary, however, is not required to be independent of the employer.\textsuperscript{263} If the monitoring fiduciary finds that there is potential for undue influence despite the existence of such procedures, the monitoring fiduciary must appoint an independent third-party fiduciary to handle 401(k) plan transactions involving company stock.\textsuperscript{264} Typical situations likely to trigger the appointment of an independent fiduciary are tender offers, exchange offers, and contested elections for directors.\textsuperscript{265}

In addition to the three basic plan design requirements, the 404(c) Regulations require that the employer (or its agent)\textsuperscript{266} provide participants certain types of information concerning the plan and its investment options. The purpose of these informational requirements is to “ensure that participants and beneficiaries in ERISA section 404(c) plans have sufficient information to make informed investment decisions.”\textsuperscript{267} One set of informational requirements mandates the types of information that must be supplied to all plan participants (mandatory information).\textsuperscript{268} The other set of informational requirements prescribes the additional types of information that must be provided only if a plan participant requests it (upon request information).\textsuperscript{269}

The mandatory information category includes: (1) an explanation that the plan is intended to constitute an ERISA section 404(c) plan and that plan fiduciaries may be relieved of liability for losses which are the result of participants’ investment instructions; (2) a description of the investment alternatives available under the plan, including a general description of the investment objectives and risk and return characteristics of each alternative; (3) an explanation of how to give investment instructions, any limits or restrictions on giving instructions, and
any restrictions on the exercise of voting, tender or similar rights; (4) a description of any transaction fees or expenses that are charged to the participant's account; and (5) a description of the additional information that is available on request and the identity of the person(s) responsible for providing that information.\(^ {270} \)

If the participant invests in a vehicle that is subject to federal securities laws, the participant must be given a copy of the most recent prospectus (unless the prospectus was furnished immediately before the participant's investment).\(^ {271} \) If the investment involves the exercise of voting, tender, or similar rights, and these rights are passed through to participants, the participant also must receive any materials related to the exercise of these rights.\(^ {272} \)

The "upon request" information category includes: (1) a description of the annual operating expenses of the plan's investment alternatives, including any investment management fees; (2) copies of any prospectuses, financial statements and reports and other information furnished to the plan relating to an investment alternative; (3) list of assets comprising the portfolio of each of the investment alternatives that hold plan assets; (4) information concerning the value of shares or units in investment alternatives available under the plan along with information concerning the past and current investment performance of each alternative; and (5) information concerning the value of shares or units in investment alternatives held in the account of the participant.\(^ {273} \)

Although the 404(c) Regulations clearly are based on the assumption that the informational requirements will enable participants to make informed investment decisions,\(^ {274} \) the regulations do not require the employer to provide plan participants with either investment education\(^ {275} \) or investment advice.\(^ {276} \)

\(^ {270} \) Id. § 2550.404c-1(b)(2)(i)(B)(1).

\(^ {271} \) Id.

\(^ {272} \) Id.

\(^ {273} \) Id. § 2550.404c-1(b)(2)(i)(B)(2).

\(^ {274} \) Id.

\(^ {275} \) See 29 C.F.R. § 2550.404c-1(b)(2)(i)(B)(1),(2) (listing mandatory and upon request disclosure information that must be provided to plan participants).

\(^ {276} \) 29 C.F.R. § 2550.404c-1(c)(4); Final Regulation Regarding Participant Directed Individual Account Plans, 57 Fed. Reg. at 46,922. Recent caselaw developments have caused experts in the employee benefits community to question whether ERISA's general fiduciary duty of prudence requires the employer to provide more and different types of information to plan participants than the mandatory and upon request information required by the 404(c) Regulations. See generally, William J. Arnone, A New Fiduciary Challenge to 401(k) Plan Sponsors, BENEFITS Q., Apr. 1, 1999, at 49 (1999) (suggesting strategies for dealing with the increased necessity for employee financial education as a means of establishing a defense to
(ii). Policy Making by the Federal Courts in Interpreting the 404(c) Regulations—Given the discretion the federal courts hold in interpreting the 404(c) Regulations, it is important to recall the first set of competing policy choices presented in this Article—employer burden versus participant protection.277 The Department of Labor’s official interpretations of the 404(c) Regulations appear to weigh heavily on the side of participant protection. These official interpretations lie in three key areas.

If faced with a sore loser case under the 404(c) Regulations, a natural reaction by a federal judge unschooled in the history and nuances of ERISA may be to start from the presumption (spoken or unspoken) that the plan participants “assumed the risk” of loss when they directed the investment of their accounts. Contrary to this intuitive reaction, ERISA historically and fundamentally protects plan participants by placing the fiduciary responsibility for ensuring the integrity of plan assets on the sponsoring employer.278 Generally, ERISA’s fiduciary protections cannot be waived by plan participants, nor can the plan’s fiduciaries be absolved from fiduciary liability for breach of their duties by the terms of the plan’s governing document(s).279

The first key Department of Labor interpretation of the 404(c) Regulations is rooted firmly in these fundamental and overarching ERISA fiduciary principles. In the preamble to the final 404(c) Regulations, the Department of Labor states that ERISA section 404(c) is similar to a statutory exception to the general fiduciary provisions of ERISA and, accordingly, “the person asserting applicability of the exception will have the burden of proving that the conditions of sections 404(c) and any regulation thereunder have been met.”280 Thus, the employer who asserts a 404(c) Regulations defense bears the burden of proof.

The second key Department of Labor interpretation of the 404(c) Regulations concerns the scope of the employer’s exemption from fiduciary liability. The Department of Labor views ERISA section 404(c) as a transactional exemption, as opposed to a blanket, plan-wide exemption. This means that

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277. See supra notes 76–78 and accompanying text.
[t]he relief from the fiduciary responsibility provisions of ERISA that is provided by section 404(c) applies only to individual transactions that meet the criteria established by that section, i.e., the transaction must be executed pursuant to the kind of plan described in section 404(c) and the participant or beneficiary must actually have exercised control with respect to the transaction. Thus, a determination whether sections 404(c)(1) and (2) apply can only be made on a case by case basis. 281

In other words, the federal courts are instructed to look at the individual circumstances of each participant, rather than reviewing (and dismissing) the claims of the plan’s participants as a whole. 282

The third key Department of Labor interpretation concerns the nature of the employer’s burden of proof. During the notice and comment process for the 404(c) Regulations, several commentators suggested that the Department of Labor adopt a reading of the Regulations as a “safe harbor.” 283 Adoption of the 404(c) Regulations as a safe harbor would have allowed an employer who failed to comply with its terms to argue that “the particular plan and any particular participant-directed transaction” fell within the statutory exemption of ERISA section 404(c). 284 The Department of Labor explicitly rejected this proposed safe harbor interpretation of the statute. 285 Consequently, if the employer fails to comply with the requirements of the 404(c) Regulations, the liability exemption of ERISA section 404(c) is not available as an employer defense.

The 404(c) Regulations are replete with adjectives that invite the exercise of judicial discretion, particularly in the area of judicial fact-finding. 286 Judicial interpretation of terms such as

281. Id. (emphasis added).
282. Such an intensive factual inquiry presents two practical problems for the federal judiciary. First, it is likely to present difficulties in the certification and trial of class action lawsuits involving the 404(c) Regulations. Second, it is likely to consume a significant amount of judicial resources, particularly at the district court level, where the federal judge acts as the trier of fact. These practical problems of case docket management, however, should not deter the federal courts from assuming the significant policy making role that has been delegated to them by the Department of Labor through the 404(c) Regulations. See infra Part III.B.
284. Id.
285. Id.
286. It is worth reemphasizing here that in ERISA fiduciary litigation there is no jury trial, and the court is the trier of fact. See supra note 12.
"reasonable," "material," "improper" or "undue" employer influence, and, most discretionary of all, "depends on the facts and circumstances of the particular case" will determine the employer's compliance with the 404(c) Regulations. Judicial discretion also applies in the evaluation of the employer's fiduciary decisions concerning the diversified range and general volatility rules governing the investment options offered under the plan.

It is through this grant of broad judicial discretion that the Department of Labor effectively delegated its policy-making role to the federal courts. Whether such delegation of agency policy-making authority to the federal courts is necessarily improper or inappropriate is beyond the scope of this Article. Rather, this Article argues that the federal courts should acknowledge and accept the significant role they play in shaping national retirement policy. The federal courts have an enormous degree of flexibility in dealing with individual cases involving 401(k) plans. This flexibility, depending on how it is asserted, can either promote or undermine national retirement policy. To ignore, either unknowingly or willingly, the broader policy implications of judicial decisions in ruling on individual cases is simply irresponsible.

The 404(c) Regulations invite the federal courts to engage in three distinct areas of policy making for 401(k) plans. The first two areas are plan structural policy and plan operational policy. The third area of judicial policy making involves company stock situations in which the employer potentially exercises undue influence over the

287. Judicial inquiry into reasonableness will be necessary when: considering whether to allow the employer to charge the expenses of carrying out investment instructions to the participant's account, 29 C.F.R. § 2550.404c-1(b)(2)(ii)(A) (2000); specifying the frequency with which participants must be allowed to transfer out of volatile investments under the general volatility rule, id. § 2550.404c-1(b)(2)(ii)(C); specifying the opportunity that must be given to the participants to exercise voting, tender, or other rights associated with the ownership of employer securities, id. § 2550.404c-1(c)(1)(ii); or, regulating transactions involving a plan fiduciary, id. § 2550.404c-1(c)(3).

288. Judicial inquiry into materiality will arise under: the diversified range rule, id. § 2550.404c-1(b)(3), and the provisions preventing the exercise of independent participant control if the plan fiduciary concealed private facts not otherwise prohibited from disclosure under federal or state securities laws, id. § 2550.404c-1(c)(2)(ii).

289. Judicial inquiry concerning the improper influence of an employer will arise in the context of any participant transactions, including the exercise of ownership rights involving employer securities, id. § 2550.404c-1(c)(2)(i), or the necessity for appointment of an independent fiduciary, id. § 2550.404c-1(d)(2)(ii)(E)(4)(ix).

290. The 404(c) Regulations require that the participant must have, in fact, exercised independent investment control. Id. § 2550.404c-1(c)(1)(i). The regulations specifically state that "whether a participant or beneficiary has exercised independent control in fact with respect to a transaction depends on the facts and circumstances of the particular case." Id. § 2550.404c-1(c)(2).

291. See supra Part II.B.3.b.
401(k) plan participants. This third area is *plan fiduciary policy*. Each type of judicial policy making is discussed below.

Plan structural policy centers around the design of the 401(k) plan itself. It involves questions such as whether the plan’s investment options satisfy the diversified range rule, or whether the plan’s investment transfer rules comply with the general volatility rule. Plan structural policy issues are characterized by their focus on the plan’s design features, which are determined by the documents that establish the 401(k) plan itself.

If the federal court determines that a plan design feature fails to meet the requirements of the 404(c) Regulations, the plan as a whole is “flawed.” A judicial ruling that a 401(k) plan has a structural flaw has consequences both at the level of the individual litigants in the action and, more importantly, the industry level. At the level of individual litigants, every participant in the 401(k) plan will have the opportunity to assert a sore loser claim against the employer. This result occurs because a plan structural flaw affects every plan participant. Under the Department of Labor’s interpretation of the 404(c) Regulations, a plan structural flaw eliminates the employer’s ability to assert a section 404(c) defense to such claims with respect to all of the participants in the 401(k) plan. The employer will be deemed responsible (and thus liable) for any investment losses incurred by each participant account that was

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292. 29 C.F.R. §§ 2550.404c-2(b) (1)(ii),(b)(3).
293. *Id.* § 2550.404c-2(b) (2)(ii)(C).
295. Final Rule Regarding Participant Directed Individual Account Plans, 57 Fed. Reg. 46,906, 46,906 (Oct. 13, 1992) (codified at 29 C.F.R. § 2550.404c-1). The Department of Labor’s commentary accompanying the final 404(c) Regulations states:

The relief from the fiduciary responsibility provisions of ERISA that is provided by section 404(c) applies only to individual transactions that meet the criteria established by that section, i.e., the transaction must be executed pursuant to the kind of plan described in section 404(c) and the participant or beneficiary must actually have exercised control with respect to the transaction.

*Id.* at 46,906 (emphasis added). A structural design feature that fails to meet the criteria established by the 404(c) Regulations will cause the plan to fail to qualify as an “ERISA section 404(c) plan.” 29 C.F.R. § 2550.404c-1(b). Thus, every participant transaction will fail to meet the standards for relief from the fiduciary responsibility provisions established by the 404(c) Regulations.

296. 29 C.F.R. § 2550.404c-1(b). The Department of Labor considered and expressly rejected a proposed interpretation of section 404(c) that characterized the regulations as merely establishing a safe harbor. Final Rule Regarding Participant Directed Individual Account Plans, 57 Fed. Reg. at 46,907. Consequently, an employer who fails to satisfy all of the 404(c) Regulation’s criteria cannot argue that “the particular plan and any particular participant directed transaction executed pursuant to such plan falls within the statutory definition. *Id.* at 46,907.
not prudently diversified. This employer liability attaches even though the employer has never exercised control over the investments in the participant’s 401(k) plan account.

A judicial ruling that a 401(k) plan is structurally flawed will have a second effect at the industry level. The full service providers who sell 401(k) plans to employers typically offer a menu of standardized plans for their customers. These standardized plans are easy, and thus inexpensive, for the employer to establish and for the service provider to administer. Standardized plans use the same basic set of plan documents and have a limited number of options concerning the plan’s design features. Thus, a ruling by a federal court that one employer’s standardized 401(k) plan is structurally flawed potentially sets up collateral estoppel claims for participants in the hundreds, or even thousands, of virtually identical 401(k) plans sold by the same service provider. Such lawsuits brought on a wide scale will have a significant chilling effect on the future establishment of 401(k) plans by employers. Given the significance of 401(k) plans to national retirement policy, the federal courts should consider carefully the potential adverse impact of such a chilling effect.

Plan operational policy centers around the actual day-to-day administration of the plan. Plan operational policy questions are intensely factual in nature. They are characterized by a focus on whether the performance of the persons responsible for operating the plan, in fact, lived up to the standards set forth in the 404(c) Regulations. An example of a plan operational policy question is whether a participant was provided with all of the required mandatory information proscribed by the 404(c) Regulations. Again,
under the Department of Labor's interpretation of the 404(c) Regulations, an operational flaw will eliminate the employer's ability to assert a section 404(c) defense. There is one highly significant difference, however, between plan structural flaws and plan operational flaws. A plan operational flaw eliminates the employer's Section 404(c) defense only with respect to the individual participant(s) affected by the operational error(s), not for all of the participants in the 401(k) plan; a structural flaw eliminates the defense with respect to all 401(k) participants.

A sore loser claim involving alleged plan operational flaws raises difficult problems of proof for the employer. These evidentiary problems arise because of the Department of Labor's position that the employer bears the burden of showing compliance with the 404(c) Regulations. As a matter of convenience, the typical employer delegates the day-to-day operation and administration of the 401(k) plan to a full service provider. Although the Department of Labor acknowledges that this practice is widespread, it nevertheless maintains that the employer remains ultimately responsible for ensuring compliance with the 404(c) Regulations.

Construed strictly, the Department of Labor's position requires the employer to prove actual operational compliance for each individual participant for every investment transaction. Such a strict approach will make the employer's evidentiary burden of proof impossible to carry in sore loser litigation. Absent a pattern and practice of blatant operational noncompliance, the federal courts must decide whether such minute and detailed operational scrutiny is necessary or desirable in light of ERISA's policy objectives.


305. See discussion supra note 295.


307. I have explained elsewhere why, for financial reasons, the full service provider is highly unlikely to be a fiduciary of the plan, and, therefore, cannot be sued for a breach of fiduciary duty under ERISA. Medill, supra note 22, at 38–49. The Supreme Court's recent ruling in *Harris Trust & Savings Bank v. Salomon Smith Barney Inc.*, 120 S. Ct. 2180 (2000), allows a plan fiduciary to bring suit against a non-fiduciary plan service provider under ERISA section 502(a)(3) for engaging in a prohibited transaction. *Prohibited Transactions: Attorneys Ponder Non-Fiduciary Liability in Aftermath of Harris Trust Ruling*, *Pensions & Benefits Daily Rep.*, June 19, 2000, at 27. Although a discussion of the new potential claims against non-fiduciary service providers made possible under *Harris* is beyond the scope of this Article, the reader should note that the remedies available to plan participants under ERISA section 502(a)(3) are, under current Supreme Court precedent, extremely limited. See infra Part III.A.

Close judicial scrutiny of the day-to-day administration of any 401(k) plan is likely to unveil a few isolated instances of operational error, even in the best administered plan. Thus, a judicial standard of strict scrutiny likely will have a chilling effect on plan sponsorship by even the most conscientious of employers. An alternative standard for resolving plan operational policy questions permits an employer to satisfy its evidentiary burden of proving compliance with the 404(c) Regulations by showing that it had procedures in place to monitor periodically the overall operational performance of the service provider. The proposed judicial standard provides a more reasonable approach to resolving ERISA's fundamental policy choice between employer burden and participant protection. An employer's delegation of plan operational responsibility to a service provider without any monitoring procedures in place puts plan participants at risk. To require such monitoring will not place an undue burden on employers. Rather, periodic monitoring of the plan's service provider is already a required fiduciary responsibility of the employer. If the employer fails to assume this fiduciary responsibility, there will be a very real consequence under the alternative judicial standard—potential employer liability for investment losses in sore loser litigation.

The alternative standard may be criticized as inconsistent with the Department of Labor's interpretation of the 404(c) Regulations as a transactional exemption. The response is that although the federal courts under Chevron must give deference to the Department of Labor's reasonable interpretation, it is exclusively the prerogative of the federal courts to determine the types of evidence that the employer can use to attempt to prove compliance. The alternative standard is similar to the well-established practice of admitting evidence of habit to prove conduct in a particular instance.

Finally, if the federal courts consistently rule that 401(k) plans have either structural or operational flaws, the courts will create an incentive for participants to select 401(k) plan investments that are not prudently diversified. If plan participants know that they stand a good chance of prevailing in sore loser litigation, they have an incentive to concentrate their 401(k) plan investments in high risk investment options that potentially carry a large reward. If these investments succeed, the participant is rewarded accordingly. If

309. See supra note 98.
310. See supra note 281 and accompanying text.
these high risk investments fail, the participant has a form of insurance against her investment losses in the form of ERISA fiduciary litigation against the employer. Encouraging this type of participant investment behavior over the long-term will undermine the effectiveness of 401(k) plans in providing retirement income security.

Plan fiduciary policy involves only 401(k) plans that offer company stock as an investment option. Under the 404(c) Regulations, such plans are subject to special fiduciary rules designed to protect participants from undue employer influence in exercising their rights as owners of company stock.\(^{313}\) Under these rules the primary safeguard for plan participants is the voluntary appointment of an independent fiduciary to handle transactions related to company stock.\(^{314}\) This appointment must be made by the employer's own designated monitoring fiduciary if it is necessary to preserve the confidentiality of plan participants in exercising their stock ownership rights.\(^{315}\)

A judicial standard of strict scrutiny for compliance with the special rules for company stock is both necessary and appropriate for the federal courts to use in resolving cases invoking plan fiduciary policy issues.\(^{316}\) Strict judicial scrutiny will send a strong signal to the employee benefits community that employers should err on the side of caution by appointing an independent fiduciary in mergers, acquisitions, and other types of corporate control contests when the employer's 401(k) plan contains company stock. Although the appointment of an independent fiduciary will necessarily place an increased burden on the employer, this burden is justified by the need to ensure employers do not improperly or unduly influence participants who have invested in company stock.

Strict judicial scrutiny also is consistent with the employer's fiduciary responsibility to select prudently the investment options for the 401(k) plan.\(^{317}\) After all, the 404(c) Regulations do not require the employer to include company stock as an investment option; they merely permit it.\(^{318}\) It is not unreasonable for employers who do decide to include company stock as an investment

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313. See supra notes 259–65 and accompanying text.
314. See supra note 264 and accompanying text.
315. See supra note 264 and accompanying text.
316. H.R. CONF. REP. No. 93-1280, at 305 (1974), reprinted in 1974 U.S.C.C.A.N. 5038, 5086 ("The conferees expect that the [404(c)] regulations will provide more stringent standards with respect to determining whether there is an independent exercise of control where the investment may inure to the direct or indirect benefit of the plan sponsor since in this case participants might be subject to pressure with respect to investment decisions.").
317. See infra Part II.B.1.c.
318. See supra note 256 and accompanying text.
option to expect that they will be held accountable for this fiduciary decision.

Finally, applying a strict scrutiny standard in individual cases involving plan fiduciary policy is unlikely to create the same type of industry-wide effect as judicial decisions determining plan structural or operational policy. The facts and circumstances surrounding cases giving rise to allegations of undue employer influence will be unique to each employer and, therefore, easily distinguishable from subsequent cases.

III. Remedies

Nowhere is the federal courts' impact on national policy more evident than in the area of ERISA remedies. Supreme Court interpretations of ERISA's remedy provisions have created several novel remedy issues the federal courts must address in future 401(k) plan fiduciary litigation.

The history of ERISA teaches that resolution of these issues is likely to have a significant impact on national retirement policy. The most prominent historical example of how judicial interpretations of ERISA remedies can negatively impact national policy lies in the health care area. In that context the federal courts have, through their interpretations of ERISA's remedy provisions, contributed to the situation where the claims of health care plan participants are routinely dismissed for lack of a remedy under ERISA, and where the persons who administer health care plans are not legally accountable for what is perceived by many observers to be self-dealing or even fraudulent misconduct, particularly by health maintenance organizations.

Will the future hold the same for national retirement policy? Much will depend on how the federal courts interpret and apply ERISA's remedy provisions to 401(k) plans.

319. See supra Part II.B.3.b.
320. This discussion of available remedies under ERISA is limited to the situation where a plan participant brings a breach of fiduciary duty claim against the plan's sponsoring employer. Remedies potentially available in other contexts, such as where a plan fiduciary brings an ERISA claim against a co-fiduciary or a non-fiduciary service provider, are beyond the scope of this Article.
A. Supreme Court Interpretations of ERISA Remedies

If a federal court finds that a breach of fiduciary duty has occurred, two remedy provisions potentially apply. The first, ERISA section 502(a)(2), operates in tandem with section 409 by authorizing "appropriate relief under section 409" for plan participants. 

ERISA section 409(a) states in relevant part:

Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary.

The second remedy provision, section 502(a)(3), authorizes a participant to "enjoin any act or practice which violates any provision of this subchapter or the terms of the plan, or ... to obtain other appropriate equitable relief ... redress such violations or ... to enforce any provisions of this subchapter or the terms of the plan."

A series of Supreme Court decisions interpreting these provisions has led to divergent paths. As interpreted by the Supreme Court, section 502(a)(2) authorizes only relief payable to the plan itself, whereas section 502(a)(3) authorizes relief to individual plan participants. The two sections also differ as to the type of relief that may be awarded. Under section 502(a)(2), money damages are available in addition to disgorgement of profits and other appropriate equitable remedies. Under section 502(a)(3), however, an individual participant is limited to remedies "traditionally viewed as 'equitable,' such as injunction or restitution." Money

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324. Id. § 1109(a).
325. Id. § 1132(a)(3).
328. 29 U.S.C. § 1109(a).
damages, the “classic form of legal relief,” are not an available remedy under section 502(a)(3).\footnote{Id. The federal courts have not reached consensus on a principled basis for distinguishing between impermissible money damages and permitted equitable remedies under section 502(a)(3). See Strom v. Goldman, Sachs & Co., 202 F.3d 138, 147-50 (2d Cir. 1999); Kerr v. Vatterott & Co., 184 F.3d 938, 944-45 (8th Cir. 1999); Allinder v. Inter-City Prods. Corp., 152 F.3d 544, 551-53 (6th Cir. 1998); Farr v. U.S. West Communications, Inc., 151 F.3d 908, 915-16 (9th Cir. 1998); Ream v. Frey, 107 F.3d 147, 155 n.5 (3d Cir. 1997); Buckley Dement, Inc. v. Travelers Plan Adm'rs, 39 F.3d 784, 787-88 (7th Cir. 1994).}

These divergent paths present crucial characterization issues for the federal courts. A 401(k) plan consists of a collection of individual accounts, one for each plan participant.\footnote{LANGBEIN & WOLK, supra note 19, at 50.} Thus, a threshold issue for the federal courts will be to determine whether the 401(k) plan participants are seeking relief for the plan (section 502(a)(2)) or the individual (section 502(a)(3)). Closely related are questions of how to characterize the requested relief to determine whether it is the type of remedy authorized by the statute.

Supreme Court precedent does not address the unique remedy issues raised by today's fiduciary litigation involving 401(k) plans. In the discussion below, three remedy scenarios are analyzed in which the federal courts are most likely to encounter these issues in order to highlight the policy implications of possible judicial interpretations of ERISA's remedy provisions. Each remedy scenario concludes by suggesting a principled course for the federal courts to follow that is in keeping with both the letter and the spirit of ERISA.

\section*{B. Remedy Scenarios}

\subsection*{1. The "I Lost Money" Scenario—In an "I lost money" scenario, the plaintiff-participants seek to recover either fees and expenses deducted from their accounts or a loss of principal to their 401(k) plan accounts. These losses may be experienced by all participants in the 401(k) plan. For example, a deduction type of loss may result from a breach of the duty of prudence because the employer selected investment options that charged excessive investment management fees to plan participants. Alternatively, the losses may be a loss of principal experienced by some, but not all, of the 401(k) plan participants. For example, a subset of plan participants may have established successfully a breach of the employer’s duty of prudent diversification of plan assets that...
resulted in investment losses to their individual accounts, and the employer's defense under the 404(c) Regulations has failed.

Should the federal courts attempt to distinguish between these two examples? One way to draw such a distinction is to say that a fiduciary breach that has harmed all of the plan's participants falls under the plan-wide remedies of section 502(a)(2), whereas a fiduciary breach that affects only some individual plan participants falls under the individual relief remedies of section 502(a)(3). A closer analysis, however, reveals that this type of line-drawing is superficial. Even though all of the plan participants in the first example may have paid excessive investment management fees, they are unlikely to have suffered equally from the employer's imprudence. The excessive investment fees charged are likely to vary with each participant's individual choice of investment options for his account. Therefore, in ordering a remedy that truly restores these losses to the "plan," the federal court must look past the plan to the loss experienced by each individual participant. What may at first appear to be an appealing bright line distinction between the two examples in application quickly becomes blurred. In both examples, the federal court will have to look beyond the symbolism of the plan to analyze the amount of the excessive fees that were deducted from each participant's individual account.

There is another, more significant, policy reason for the federal courts to treat both examples similarly. If the federal court rules that a fiduciary breach affecting fewer than all of the plan's participants can only be remedied under section 502(a)(3), the limited traditional equitable remedies available under this section may leave this subset of participants without any relief at all, or "betrayed without a remedy." Such a result—a fiduciary breach with no available remedy—nullifies the fiduciary responsibility provisions of ERISA. Such an interpretation sends a clear signal to the employee benefits community that employers may disregard their statutory obligations with impunity. The long-term policy

332. Medill, supra note 22, at 58-60.

333. I view this as means to consider the compounded effect of subsequent lost investment earnings. See supra note 151 and accompanying text. These subsequent lost investment earnings could, however, also be characterized as an opportunity loss. See infra Part III.B.2.

334. To award relief under section 502(a)(3) in the second example, the restoration of investment losses resulting from the employer's breach of its duty of prudent diversification, would be "restitution." Effectively, however, what will be paid is money. When, if ever, an award of money in ERISA fiduciary litigation can properly be characterized as restitution and not money damages is one of the most contentious issues being litigated in the federal courts today. Dana M. Muir, ERISA Remedies: Chimera or Congressional Compromise?, 81 IOWA L. REV. 1, 36-38 (1995); see sources cited supra note 330.
consequence is likely to be a significant undermining of the effectiveness of 401(k) plans in providing retirement income security.

The better judicial interpretation for both examples under the I lost money scenario is to view the relief as flowing to the plan in accord with section 502(a)(2), so long as the monetary award is initially allocated to each participant's plan account rather than to his personal pocketbook. Such a distinction easily can be made. In both examples above, an award of money damages to the plan will be made payable directly to the plan's trustee. The plan trustee will then allocate the payment among the participants' individual accounts. The plaintiff-participants will be unable to access their litigation award except through the normal operating provisions of the plan. By requiring that the damages award must be paid to the plan itself, this approach is consistent with ERISA's fundamental purpose of protecting and preserving the retirement benefits the 401(k) plan provides to its participants.

2. The I Should Have Earned More Money (Opportunity Loss) Scenario—The opportunity loss scenario occurs when the plaintiff-participants' alleged injury is not that their plan accounts have suffered a loss of principal or excessive fee deductions, but rather that their accounts should have earned more money. In essence, their retirement benefits, represented by the balance of their 401(k) plan accounts, are less than they otherwise would be because of the employer's breach of fiduciary duty. Their loss is one of lost investment opportunity.335

This scenario is likely to arise in the context of automatic enrollment 401(k) plans.336 Recall that in an automatic enrollment plan, the employer enrolls all of its eligible employees as participants and retains fiduciary responsibility for investing the contributions of participants who fail to make an affirmative investment direction.337 This default investment by the employer is usually a safe, low-earning option, such as a stable value or money

335. An "opportunity loss" measure of damages under ERISA section 409 has been used by the federal courts in a variety of other contexts. See GIW Ind. v. Trevor, Stewart, Burton & Jacobson, Inc., 895 F.2d 729, 733-34 (11th Cir. 1990); Dardaganis v. Grace Capital Inc., 889 F.2d 1237, 1243-44 (2d Cir. 1989); Donovan v. Bierwirth, 754 F.2d 1049, 1055-56 (2d Cir. 1985); Katsaros v. Cody, 744 F.2d 270, 281 (2d Cir. 1984); Donovan v. Mazzola, 716 F.2d 1226, 1232-33 (9th Cir. 1983). But see Kerr v. Vatterott & Co., 184 F.3d 938, 944-45 (8th Cir. 1999). The federal courts construe any uncertainty in quantifying an opportunity loss attributable to a breach of fiduciary duty against the fiduciary, not the injured plan. E.g., Dardaganis, 889 F.2d at 1244; Bierwirth, 754 F.2d at 1056.

336. See supra Part II.B.3.a.

337. See supra Part II.
market mutual fund. Thus, the participant’s account never loses money, but its investment earnings are far less than they would have been had the employer chosen a more diversified range of investments.

On the surface, the opportunity loss scenario represents merely questions of semantics. Is an opportunity loss within the meaning of section 502(a)(2), and therefore remediable under that provision? Alternatively, is restoring a lost opportunity closer in nature to restitution, and thus an equitable remedy available under either section 502(a)(2) or section 502(a)(3)? ERISA’s legislative history is silent on these questions.

The deeper policy issue is whether ERISA should remedy an opportunity loss type of injury in the 401(k) plan setting? Here the nature of retirement benefits provided by a 401(k) plan argues strongly for a remedy. It is the tax-deferred investment earnings that build up inside the 401(k) plan account, much more than the participant’s contributions, that will cause the participant’s retirement benefit to grow over time to an amount that represents a measure of retirement income security. Denying a remedy for the lost opportunity of greater investment earnings significantly undermines the very economic engine that makes 401(k) plans successful.

How the federal courts resolve this remedy issue will determine the fate of automatic enrollment 401(k) plans. As noted above, if the federal courts universally deny a remedy for the participants’ opportunity losses resulting from the employer’s decision to invest their undirected accounts in a money market fund, automatic enrollment 401(k) plans with low-earning default investment options may become the norm.

From the perspective of national retirement policy, promoting the growth of automatic enrollment plans is desirable because more people will be saving for their retirement. Limiting employer liability by denying participants a remedy for opportunity losses would encourage more employers to adopt automatic enrollment 401(k) plans. But will allowing a remedy for the participants’ opportunity losses necessarily deter the growth of automatic enrollment plans? To the contrary, if the federal courts provide appropriate advice to the employee benefits community,

338. Profit Sharing/401(k) Council of America, supra note 215; Barnhart, supra note 212; Eve Tahmincioğlu, Ready or Not, Welcome to the 401(k) Plan, N.Y. Times, Aug. 20, 2000, at C10.
339. See supra note 88.
340. See supra note 213.
the policy benefits of automatic enrollment plans will not only be preserved, but can be greatly enhanced.

To follow this logic, assume that the federal courts decide that the employer in the automatic enrollment example above is liable for opportunity losses incurred by plan participants whose undirected accounts were invested in the money market fund. The question for the employee benefits community then becomes how to counsel an employer to structure its default investment option under an automatic enrollment arrangement to best insulate the employer from such liability. The federal courts can answer this question in advance by providing clear and explicit guidance, or advice, concerning the types of investments that will satisfy the employer’s interrelated fiduciary duties of prudence and prudent diversification of plan assets in designing the plan’s default investment option.

If these duties are fulfilled, over the long-term the participants placed in the default investment option are likely to have a much larger retirement benefit from their 401(k) plan account, a clear policy benefit. It is possible, of course, that the most prudently selected default investment option may nevertheless result in an investment loss. If, however, the employer has satisfied its fiduciary duties in structuring the default investment option, it should not be liable for an investment loss. Under this approach, clear and reliable advice to employers concerning their fiduciary duties in selecting a default investment option can reduce significantly the potential deterrent effect resulting from a determination that opportunity losses are remediable under ERISA.

Employers predictably will react to clear and reliable judicial advice by adopting default investment options for their automatic enrollment plans that mirror the investment gains of the stock market. One obvious choice is an index fund. Another possibility is a balanced fund containing a mixture of investments in both bonds and equities. Perhaps the most prudent choice will be to select a “lifecycle” fund that corresponds to the age of the participant. If employers adopt these types of default investment options, not only will more employees be saving for retirement, but over the long-term, participants in the default investment option are likely to have much larger 401(k) plan retirement benefits. Conversely, judicial attempts at advice giving in this area that are inconsistent and confused will have a significant chilling effect on the future growth of automatic enrollment 401(k) plans.

3. The Employer Made Money Off Me Scenario—The “employer made money off me” scenario occurs in cases in which the
employer has breached its duty of loyalty by self-dealing with the assets of the 401(k) plan. This scenario may overlap with both the "I lost money" and the "I should have made more money" scenarios described above. For example, assume that the accounts of the 401(k) plan participants paid excessive investment management fees to their employer, who is itself a plan service provider. Under this scenario the plaintiff-participants will have suffered a loss of principal, and the employer will have made a profit.\footnote{341}

It is also possible that the plaintiff-participants under this scenario may not have suffered a loss of principal, only an opportunity loss. For example, the employer unilaterally replaces the high-flying stock of another company (Company A) with its own lesser performing company stock (Company B). The 401(k) plan participants who used to hold Company A stock do not lose money on their Company A stock, but they would have had a greater investment return if they had been allowed to retain their Company A stock instead.\footnote{342}

As in the opportunity loss scenario, the question arises as to how to define the "profit" that the employer must disgorge under section 502(a)(2). The profit made by the employer's breach in the second example above is difficult to measure. Must there have been a profit in the revenue/accounting sense? Will a rise in the employer's company stock price due to increased demand created by a large purchase for the 401(k) plan constitute a profit? Or does any benefit to the employer that is more than incidental constitute a profit? Whatever measure of profit the federal courts adopt, any ambiguities should be construed against the disgorging employer.\footnote{343}

Fiduciary claims involving an employer's self-dealing in 401(k) plan assets also relate to whether the participants' claims are remediable under section 502(a)(2) or section 502(a)(3).\footnote{344} A federal court has yet to rule that disgorgement of profits by the employer falls within the Supreme Court's narrow interpretation of "traditional equitable remedies" available to a plan participant.


\footnote{343. \textit{Cf.} Dardaganis v. Grace Capital Inc., 889 F.2d 1237, 1244 (2d Cir. 1989) (finding that ambiguity in measurement of loss should be construed against the fiduciary); Donovan v. Bierwirth, 754 F.2d 1049, 1056 (2d Cir. 1985) (same).}

\footnote{344. See supra Part III.A.
under section 502(a)(3). Disgorgement is, however, a permitted statutory remedy under section 502(a)(2). Thus, resolution of this characterization issue may determine whether or not a remedy exists at all for the plaintiff-participants.

Again, the better characterization from a policy perspective is a remedy payable to the plan under section 502(a)(2). Employer misuse and self-dealing in plan assets lay at the heart of the fiduciary misconduct that drove Congress to enact ERISA. The best way to deter such employer conduct is to allow for an effective remedy. The more broadly these disgorged profits are defined by the federal courts, the more effective this deterrent will be.

**Summary**

Many workers today depend on their 401(k) plan to provide them with an adequate income during retirement. For these workers to achieve retirement income security, their 401(k) plan investments must perform well over their working lifetime. Employers’ selection of investment options for the 401(k) plan, a fiduciary duty under ERISA, plays a critical role in determining investment performance.

Federal court interpretation of this fiduciary duty will shape future national retirement policy. In interpreting employers’ duty of prudence, federal courts must balance the burden on each employer to investigate diligently investment options against the importance of this task in determining the retirement income of 401(k) plan participants. Federal courts should scrutinize, in particular, the level of fees associated with the investment options selected by the employer because of their adverse long-term impact on 401(k) plan retirement savings. The federal courts also should apply a heightened standard of prudence if the employer chooses to include company stock as an investment option because

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348. *See* Bierwirth, 754 F.2d at 1056 (recognizing that fiduciary abuses may be deterred by imposing personal liability on the fiduciary through ERISA’s section 409 remedies).
it presents a higher degree of investment risk than a diversified mutual fund.

Interpretation of employers’ duty presents a different policy analysis for federal courts. Federal Courts must determine whether, in selecting the 401(k) plan investment options, employers have received permissible incidental benefits or engaged in prohibited self-interested conduct. This Article illustrates how employers can engage in prohibited self-serving conduct when selecting (or deciding whether to retain) 401(k) plan investment options. Such conduct may take the form of selecting investment options with higher fees in exchange for lower out-of-pocket administrative costs for the employer. If the employer selects or retains company stock as an investment option, numerous opportunities exist for conflicts of interest to arise between the employer and the 401(k) plan participants.

Employers today rely upon the Department of Labor’s 404(c) Regulations to allow participants to select among plan investment options without incurring potential fiduciary liability. A number of policy issues will arise as federal courts interpret the details of the 404(c) Regulations. This Article cautions against judicial interpretations of the 404(c) Regulations that will have a potential chilling effect on voluntary plan sponsorship by employers. This Article also addresses an important exception to the 404(c) Regulations, the automatic enrollment plan. The federal courts are urged to interpret ERISA’s duty of prudent diversification of plan assets and remedy provisions to encourage the employer to select a default investment option for automatically enrolled participants that is broadly diversified in the equity markets, rather than a low-earning money market fund.

Federal courts are likely to confront three potential remedy scenarios in future 401(k) plan fiduciary litigation. Plan participants may be injured by an employer’s imprudent selection of investment options for the 401(k) plan, either in the sense of a monetary or opportunity loss. Alternatively, plan participants may be injured by an employer’s self-dealing misconduct with respect to plan investment options. Consistent with Supreme Court and existing federal caselaw concerning ERISA remedies, federal courts can and should afford each type of injury a remedy.

The future of national retirement policy will be shaped by the degree of retirement income security that participants achieve through their 401(k) plans. Stock market volatility places 401(k) plan participants at risk of having an inadequate income for their retirement. Such risk will either be mitigated or exacerbated by
the cumulative impact of judicial interpretations of ERISA's fiduciary duty provisions to individual 401(k) plan cases brought before the federal courts. The hypothetical litigation scenarios presented in this Article illustrate the significant policy choices the federal courts will confront, knowingly or unknowingly, when applying ERISA's fiduciary duty provisions to 401(k) plans. Finally, this Article challenges the federal courts to recognize and, most importantly, embrace their policy-making role when rendering decisions in individual cases.