# TESTIMONY

## U.S. Senate
## Committee on Governmental Affairs
## Enron Hearings

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My name is Susan Stabile. I am a Professor of Law at St. John's University School of Law in New York City, where I teach courses in pensions and employee benefits and employment law. Prior to joining the St. John's faculty, I was associated with the law firm of Cleary, Gottlieb, Steen and Hamilton, where my practice was concentrated in the employee benefits area. Among other areas of my scholarship, I have been researching and writing about 401(k) plans for the last several years.[1] I have been particularly concerned about the heavy accumulations of employer securities by employees who participate in 401(k) plans and I appreciate very much this opportunity to testify before you today concerning the pension aspects of the Enron situation.

In this statement, I will briefly address three points:

- First, current law permits employees to invest an unlimited amount of their 401(k) account balances in employer securities. If permitted to do so, employees will disproportionately invest in employer stock, with the result that the retirement security of millions of workers is at risk. Given the reasons for this disproportionate investment, it is desirable that Congress impose limits on acquisitions of employer securities by 401(k) plans.
- Second, although the losses suffered by Enron employees are likely to be replicated if any number of other large U.S. corporations suffers a serious financial downturn, improper behavior by persons ERISA designates as fiduciaries to Enron's 401(k) plan may have aggravated the losses. Current law, however, is sufficient to address that improper behavior.
- Third, in considering what action to take to try to prevent future employee losses, Congress should not be moved by threats that employers will offer less generous benefits or will suffer from an inability to provide incentives to their employees. Competitive and other pressures will force companies to continue to provide benefits to their employees; and employees can be sufficiently motivated without bloating their retirement accounts with company stock.

*I. The Non-Uniqueness of the Enron Pension Catastrophe*

At the end of 2000, 62% of Enron's 401(k) plan assets were invested in Enron common stock.[2] That makes Enron's 401(k) plan no different from that of many other companies. Most 401(k) plans of large public companies have an employer stock fund. Employees who participate in 401(k) plans that do offer an employer stock option invest an average of about one-third of their plan assets in company stock.[3] The 401(k) plan assets of one in five companies is at least 50% invested in the company's own stock[4] and at some companies the figures are much higher. Just to give some examples:

- Proctor & Gamble – 94.7% invested in employer securities;
- Sherwin-Williams – 91.6% invested in employer securities;
- Abbott Laboratories – 90.2% invested in employer securities;

- Pfizer – 85.5% invested in employer securities.[5]

The law does nothing to prevent these vast accumulations of employer stock in employee's 401(k) plan accounts. ERISA, the federal statute that regulates pension plans of private employers, does label as a fiduciary those persons responsible for investing plan assets and imposes on fiduciaries a statutory obligation to live up to certain standards of behavior. However, notwithstanding the statute's designation of those who exercise control over investment of pension plan assets as a fiduciary, ERISA specifically provides that employees who exercise control over their plan accounts are not deemed to be fiduciaries by reason of such exercise. Therefore, although heavy plan investments in a single security would seem to violate both ERISA's prudence and diversification standards, those standards have no applicability to participant decisions.

The regulatory regime for 401(k) plans is thus very different from that of traditional defined benefit plan. Traditional defined benefit plans promise payment of a certain benefit on retirement. That benefit is funded by employer contributions that are invested by professional asset managers subject to fiduciary standards. Any risk of poor investment experience is born by the employer. In 401(k) plans, where the benefit received is completely a function of the investment experience of contributed funds, investment decisions are made by individual plan participants, who may have no financial sophistication or access to investment advice, and who are subject to no standards whatsoever.

ERISA does impose some limits on acquisitions of employer securities by pension plans. The statute limits the acquisition of employer securities by defined benefit plans and by employer-directed defined contribution plans to up to 10% of the plans' assets. However, no similar limits apply to acquisitions by participant-directed plans, and 87% of 401(k) plans, accounting for 83% of active plan participants, provide for participant direction.[6]

The law also permits employers to make matching contributions in the form of employer stock. Many companies take advantage of this ability, requiring that matches be made in company stock and imposing long waiting periods before allowing employees to switch such matching contributions to another investment alternative.[7] A recent survey by the Employee Benefits Research Institute found that matches are required to be invested in company stock in 43% of 401(k) plans offering an employer stock fund.[8]

Why do so many employees invest such significant portions of their plan account balances in employer securities? It is worthwhile to briefly consider the reasons for such heavy investments, because the reasons are instructive on the question whether this lack of diversification can be successfully addressed by increased education and disclosure.

First, as Enron employees testified during hearings held in December by the Senate Commerce Committee, many employees invest heavily in employer stock out of a sense of loyalty to their employer.[9] Although this is not an issue on which I have seen empirical work, loyalty as a factor in investments in employer securities is something commonly raised in academic literature and in press reports of discussions with employees. It appears that investment in employer securities is very much an emotional issue. Even employees who understand the value of diversification in the abstract and who say they would never advise a friend or relative to be so heavily invested in a single security, put large portions of their own account balance in the stock of their employer. This is not just a question of lack of financial sophistication, as illustrated by the example of a GM executive several years ago who, despite his participation in all discussions with analysts about the company's financial prospects, insisted on investing enormous amounts in GM stock as the stock was falling. By the time the stock finished plummeting, he lost $160,000 of his retirement money.[10]

Closely related to their own feelings of loyalty is the sense on the part of many employees that they are expected by their employer to invest heavily in company stock, that is, that the corporate culture encourages such investment or that employers will perceive as loyal those employees who so invest. Actual or perceived pressure by the employer is a much harder phenomenon to document. However, ERISA's legislative history suggests that Congress was concerned with the possibility that employees might be pressured by employers to acquire company stock[11] and the complaints in both a lawsuit filed against Lucent Technologies in July of 2001 and in some of the employee suits filed against Enron allege that the employers improperly induced employees to invest.

Additionally, practices like requiring matching contributions to be invested in company stock and offering company stock at a discount to employees suggest that employers do attempt to influence employees' investment decisions. Those practices are successful. A recent study by the Employee Benefits Research Institute found that the effect of a plan requiring matching contributions to be invested in employer securities is to cause employees to direct a higher percentage of their self-directed funds there as well.[12] This phenomenon may be explained by what one researcher has termed an "endorsement effect" – employees interpret matches in employer securities as an "endorsement or as implicit investment advice."[13]

Finally, many employees invest heavily in their employer's stock because of overconfidence in the employer and an optimistic bias that makes them think that other companies are more likely to experience downturns than their own.[14] Employees feel a greater comfort and certainty with the stock of their employer, feeling that an investment there is less risky than an investment elsewhere. This is particularly understandable given that an employee is faced with the choice among an array of unfamiliar investment options and his own employer's stock, which is familiar and comfortable.

What all of this means is that, for reasons that are heavily emotional and psychological, if employees are given unlimited ability to invest in employer securities, they will invest disproportionately large portions of their 401(k) account balance in employer securities. This suits the interests of employers: employees represent a group of stockholders who are not likely to operate as an effective check on management. Indeed, one motive for employers to include a company stock fund as a 401(k) investment option is precisely that it serves as a means of placing large blocks of shares in friendly hands. Employers believe that employees will be more concerned with current job security than with the future value of their retirement benefit and thus will make voting and tender offer decisions that favor the interests of current management. There is good basis for that belief. According to a survey conducted several years ago by the Employee Benefit Research Institute, 65% of plan participants indicated that they would not vote in favor of acquisition of their employer by a hostile acquirer even if doing so would result in a 50% return on their investment, and 56% said they would do so even for a 100% return on their investment.[15] At a minimum, employee shareholders are less likely to be vocal antagonists to management positions.

While heavy accumulations of employer securities in 401(k) plan accounts may be good for management, Enron's fall has graphically illustrated that it is not good for employees. If we are concerned with ensuring adequate retirement security, it is necessary to consider regulation in this area. Given the reasons for such heavy employee investment in employer securities (which have little to do with a failure to understand in general terms the value of diversification), I am not confident that simply requiring more disclosure will be effective. Therefore, as I have advocated in my writings, I believe Congress should consider imposing limits on the percentage of a participant's account balance that is invested in employer securities. Since the law already imposes a limit on the acquisition of employer securities by defined benefit pension plans and by employer-directed defined contribution plans, such a change would simply extend that regime to participant-directed 401(k) plans.

*II. The Unique Enron Wrinkles*

As I suggested in the first portion of my remarks, to a large extent the law permits creation of a scenario that will result in large participant losses in the event of a financial catastrophe such as Enron. There is no limit on how much of a participant's account balance can be invested in employer securities. Employers are permitted to match in company stock and to prevent their employees from transferring matching contributions out of that stock for many years.

None of that, however, excuses Enron for making a bad situation worse. Let me briefly address two issues. The first is what has been referred to as the "lockdown," the fact that employees were prevented from moving funds out of the employer stock fund for a disputed period in late October. The second is the question of possible misrepresentations to employees.

1. The Lockdown. Under the version of the facts most favorable to the company (and these facts are based on news reports and company press releases): In February 2001 Enron decided to change plan administrators, a change that would require a period in which plan accounts would be frozen to allow an orderly and accurate transfer of records to the new administrator. (This is the period of time referred to as the lockdown. It is also sometimes referred to as a "transaction suspension period" or a "blackout.") In September and October 2001, employees received various e-mails informing them of the dates of the lockdowns. For a disputed number of days, occurring roughly from the middle of October to the middle of November, employees were prevented from moving shares out of the employer stock fund, and this was a time during which Enron's stock was steadily declining in value.

Those who make decisions regarding the administration of pension plans are fiduciaries subject to statutory standards of prudence and loyalty to plan participants. A decision to impose a lockdown for the purpose of propping up the company's stock value obviously would breach a duty of loyalty to plan participants. A lockdown to facilitate a transfer of plan records to a new administrator is a routine[16] and permissible action. Such a suspension of trading is necessary to that the new recordkeeper can verify the accuracy of accounts.

However, even if the motive for the Enron lockdown in October/November was to facilitate transfer to a new administrator, one has to question the decision of the plan fiduciaries to go ahead with the lockdown in light of the circumstances then prevailing. That is, by the time the actual lockdown was set to occur, it should have already been clear to those making plan decisions that the company's financial situation was precarious at best. Therefore, preventing plan participants from being able to transfer out of the company stock fund at that particular point in time was neither prudent nor in the best interests of plan participants. It is hard to imagine any compelling reason that the change in administrator had to occur when it did. Some plan fiduciary, acting in the best interests of plan participants, should have made the decision that the transfer to the new plan administrator could be delayed. The failure to do so should be viewed as a breach of the ERISA fiduciary duties of loyalty and prudence, thus entitling employees to a remedy under current law.[17]

Let me emphasize that lockdowns *per se* are not a problem. They are routine and necessary to deal with changes in administrators, changes in the plan, such as changes in frequency of valuations of accounts, and changes in corporate structure, such as mergers. Clearly employees should have prior notice of lockdowns and, equally clearly, a lockdown should not be timed to coincide with foreseeable downward movement in a company's stock. I believe that both of those are required by ERISA's general standards of prudence and loyalty.

2. Possible Misrepresentations. A second issue concerns the disclosures that were made to plan participants during the late summer and early fall of 2001. Again, based on public reports in the press, it appears that insiders knew that Enron was in serious trouble as early as last spring. However, as late as August, employees were

receiving e-mails from Enron's CEO talking about the company's rosy prospects for the future. Additionally, it appears that there were various employee meetings at which employees were assured of the company's good future by the CEO and others.

ERISA has nothing to say about what a company CEO tells his employees about a company's prospects. What ERISA does prohibit, as a violation of its fiduciary standards, is misrepresentations from a plan fiduciary to plan participants. The question of when a company official is wearing his "fiduciary" hat or his "employer" hat is one that frequently gives courts difficulty. However, in 1996, the Supreme Court, in *Varity v. Howe*,[18] provided some guidance on this question as it relates to statements about the company and its prospects. The Court held that statements about a company's future prospects, if they are made in the context of discussions about the company's benefit plans and by persons who employees would perceive to be acting in the capacity of plan administrator as well as employer, may be viewed as statements made by a fiduciary. Depending on the nature of the Enron employee meetings and the content and purpose of the e-mails and other written materials sent to employees, there is at least a question whether a fiduciary misrepresentation was made to plan participants. If such misrepresentations were made, employees have a claim under ERISA to restore their losses. Whether they can find defendants with sufficient assets or insurance to pay the losses is a different question.[19]

*III. Beware the Rhetoric*

The devastating effects of Enron's financial collapse to 401(k) plan participants have obviously prompted many to call for reconsideration of the laws regulating private pensions. Those calls for change will be met by warnings of doom and it is important to look through the broad rhetorical statements that will be made.

1. <u>The prediction (threat) that employers will offer less generous benefits</u>. From the time ERISA was contemplated, claims have been made that increased pension regulation will cause employers to stop offering pension plans or to fund them less generously. In the context of employer securities, the claim is made that if you don't let employers match in company stock, or if you force them to allow employees to diversify matching contributions that are made in company stock, employers will stop making matching contributions.

The claim is unpersuasive. From a competitive point of view, employers will fear that not offering matching contributions will make them less attractive compared to other companies that do offer matching contributions. Moreover, matching contributions are used by employers to induce participation in 401(k) plans by their lower-paid employees.[20] That participation in important for two reasons. First, employers need for their older employees to be able to retire to make room for the hiring of new employees, and it is therefore in their interest for employees to build up 401(k) account balances. Second, the Internal Revenue Code requirements for tax qualification of pension plans include nondiscrimination rules designed to ensure that plans not discriminate in favor of highly compensated employees. The rules as they currently exist (the rules having been vastly simplified by the Small Business Job Protection Act of 1996) provide a safe harbor for plans that provide a certain level of employer matching contributions or that provide a minimum nonelective employer contribution. Plans that do not meet the safe harbor have to undergo complex testing that requires extensive record keeping, monitoring and calculations. Moreover, to pass that test, it is still important that lower-income employees participate in the plan. Thus, important motivations for matching contributions remain even if employers cannot match in company stock.

2. <u>The claim that employers need to be able to motivate their employees with stock.</u> Employers argue that it is important for them to match in stock and encourage employees to hold significant amounts of stock in their 401(k) plan accounts to better motivate employees and align their interests with those of shareholders. This argument raises the question whether the benefits of broad-based stock ownership

through a vehicle such as a 401(k) plan outweigh the concerns raised by significant acquisition of employer securities in 401(k) plans.

There are reasons to question whether broad-based stock ownership through retirement plans significantly contributes to employee motivation and incentive. Much of the purported evidence of improved company performance speaks in general terms about stock ownership and is not linked to *plan* ownership. If employee ownership does positively affect worker productivity, it is more likely to do so when employees hold stock directly than when the employee has merely a right to receive a value of shares at a time long in the future. The latter is much less visible, especially to employees who rarely look at their plan statements. In fact, according to one study that considered data from 1990-1996, the average total shareholder return in companies that had employer securities in their defined contribution plans did not differ from the average return of those companies without any employer securities.[21] The same study found "some supportive evidence" of a positive relationship between risk-adjusted stock returns and employee ownership, but it was nonlinear, i.e., the presence of some stock was helpful, but more stock was not more beneficial.[22] This suggests that it is possible to get whatever benefit there is to be obtained from plan stock ownership without massive accumulations that put retirement security in jeopardy. Thus, if employers want to provide incentives to their employees, let them do so outside of their pension plans, the primary purpose of which is to provide retirement security.

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When ERISA was enacted in 1974, the dominant means of providing pension benefits was the defined benefit pension plan, which promised participants a stated annual pension for their lifetimes. In stark contrast, it is now the case that defined contribution plans account for over 80% of pension plans and over 60% of plan participants.[23] Notwithstanding earlier data that appeared to suggest otherwise, for many employees, their 401(k) plan is their only meaningful source of employer-provided retirement income, not merely a supplemental plan providing a tax-deferred investment for affluent employees.[24] Thus, ensuring the safety and soundness of 401(k) plans is essential to securing retirement security for American workers.

Congress made the decision a long time ago that adequate retirement security was an important national objective. Federal law grants an enormous tax subsidy to tax-qualified pension plans to promote retirement savings. Because society bears the cost of this tax largesse and will bear the cost of massive numbers of individuals retiring with inadequate plan account balances, the government has an interest in making sure the system that it has created achieves its objectives. I support suggestions for increased disclosure, but I do not believe additional disclosure standing alone is sufficient. Congress should seriously consider legislation that would limit the percentage of a participant's 401(k) plan account balance that can be invested in employer securities to conform to the limits currently in place for defined benefit plans and employer-directed defined contribution plans.

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[1] Susan J. Stabile, *The Behavior of Defined Contribution Plan Participants*, Forthcoming, New York University Law Review (2002); Susan J. Stabile, *Paternalism Isn't Always A Dirty Work: Can the Law Better Protect Defined Contribution Plan Participants*, Forthcoming, Employee Rights and Employment Policy Journal (2001); Susan J. Stabile, *Pension Plan Investments in Employer Securities: More Is Not Always Better*, 15 YALE J. ON REG. 62 (1998).

[2] Patrick Purcell, *The Enron Bankruptcy and Employer Stock in Retirement Plans*, CRS Report for Congress, Jan. 22, 2002, at p.3. Eighty-nine percent of this represents stock purchased by employees and the rest is attributable to company matching contributions. *Id*.

[3] Sarah Holden and Jack VenDerhei, *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2000*, 7 INVESTMENT COMPANY INSTITUTE PERSPECTIVE at 9, Figure * (Nov. 2001). Overall, employer stock represents 19% of all 401(k) assets, but that percentage includes all plans. *Id*. Participants in plans offering company stock have "dramatically lower allocations to equity funds and balanced funds" than plans without company stock funds. *Id*.

[4] *See* Theo Francis, *Company Stock Fills Many Retirement Plans Despite the Potential Risks to Employees*, WALL ST. J., Sept. 11, 2001 (reporting result of study of Institute of Management and Administration).

[5] Patrick Purcell, *The Enron Bankruptcy and Employer Stock in Retirement Plans*, CRS Report for Congress, Jan. 22, 2002, at p.4, Table 1.

[6] United States Department of Labor, Pension and Welfare Benefits Administration, Abstract of 1997 Form 5500 Annual Reports, Private Pension Plan Bulletin No. 10 (Winter 2001), *available at* www.dol.gov/pwba/public /programs/opr/bullet97).

[7] Theo Francis, *Company Stock Fills Many Retirement Plans Despite the Potential Risks to Employees*, WALL ST. J., Sept. 11, 2001 (noting that many employers match employee 401(k) contributions with company stock and giving Gillette, Abott Labs and Coca-Cola as examples of such companies); Jim Davenport, *When All the Eggs are in the Company Basket*, CHI. TRIB., Aug. 14, 1995, at 3 (reporting finding of Buck Consultants that 18% of all companies surveyed, and 40% of the largest companies surveyed, matched contributions with employer stock).

[8] Jack L. VenDerhei, *Company Stock in 401(k) Plans: Results of a Survey of ISCEBS Members*, EBRI Special Report, Jan. 28, 2002, at p.5.

[9] I discuss the loyalty issue more extensively in both the Yale Journal on Regulation and NYU articles cited in footnote 1.

[10] Lewis Braham, *Institutional Asset Management: The Growing Number of Options in Qualified Plan is Boom for Planners in the Short Run But Could Spell Trouble in the Long*, FIN. PLAN., Jul. 1, 1997.

[11] H.R. REP. NO. 1280, 93d Cong., 2d Sess. at 305 (1974).

[12] Sarah Holden & Jack VanDerhei, *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2000*, 7 INVESTMENT COMPANY INSTITUTE PERSPECTIVE at 10 (Nov. 2001) (33% of participant contributions invested in employer securities where company matches in stock compared to 22.2% of participant contributions invested in employer securities where company does not direct investment of the match). *See also* Jack L. VenDerhei, *Company Stock in 401(k) Plans: Results of a Survey of ISCEBS Members*, EBRI Special Report, Jan. 28, 2002, at p.2 (reporting survey results confirming earlier findings).

[13] Shlomo Benartzi, *Excessive Extrapolation and the Allocation of 401(k) Accounts to Company Stock*, 61 J. OF FIN. 1747, 1752 (2001).

[14] *See id*. at 1748 (noting that employees conclude that high past performance of the employer is representative of future performance, giving them inflated confidence in the employer); Maya Kroumova Kroumova, *Investment in Employer Stock Through 401(k) Plans: Is There Reason For Concern?*, Dissertation, Graduate School – New Brunswick Rutgers, the State University of New Jersey, Jan. 2000, at p. 75 (citing findings of Kahneman, Knetsch & Thaler).

[15] Employee Benefit Research Institute, *Public Attitudes on Employee Ownership and Benefit Promises*, EBRI/GALLUP REPORT G-54 (1994).

[16] According to research conducted by the Profit Sharing/401(k) Council of America, on any given business day, 96 401(k) plans are in a lockdown. Dennis K. Berman, *Accounting for Enron: All Tied Up: Retirement Plan Lockdowns at Lucent and Elsewhere Draw Questions*, WALL ST. J., Jan. 21, 2002, at C14.

[17] It also appears from press reports that employees may have received conflicting information about when the lockdown would begin. If employees were misled (intentionally or otherwise) about the timing of the lockdown and were unable to sell at a time they thought selling would be possible, that may give them another claim.

[18] 516 U.S. 489 (1996).

[19] The reality that recovery may be impossible suggests that value of an approach that limits employees' exposure to employer securities rather than relying on a lawsuit after the stock has lost its value.

[20] Jack VanDerhei and Craig Copeland, *A Behavioral Model for Predicting Employee Contributions to 401(k) Plans,* 5 NORTH AMER. ACTUARIAL J 80 (2001) (finding availability and level of matching contributions to be primary impetus for participant contributions).

[21] *See* Maya Kroumova Kroumova, *Investment in Employer Stock Through 401(k) Plans: Is There Reason For Concern?*, Dissertation, Graduate School – New Brunswick Rutgers, the State University of New Jersey, Jan. 2000, at p. 138-39.

[22] *Id*. at 139.

[23] *See* U.S. General Accounting Office, Report to the Chariman, Special Committee on Aging, and the Honorable Judd Gregg, U.S. Senate, *401(k) Pension Plans: Loan Provisions Enhance Participation But May Affect Income Security for Some*, GAO/HEHS-98-5, October 1997, at p.3.

[24] *See* Leslie E. Papke, *Are 401(k) Plans Replacing Other Employer-Provided Pensions? Evidence From Panel Data*, NBER Working Paper Series, Working Paper 5736, August 1996 (concluding that more recent data suggests that 401(k) plans are replacing defined benefit plans rather than serving as a means for additional savings and also citing early contrary findings).