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Economic Analysis and the Prudent Man Rule Under ERISA: Efficiency Versus The Public Interest

On Labor Day, September 2, 1974, President Gerald Ford signed into law the Employee Retirement Income Security Act of 1974 (ERISA),¹ culminating a decade of public expression and legislative response.² In so signing President Ford ratified a law whose com-

1. Act of Sept. 2, 1974, Pub. L. No. 93-406, 88 Stat. 829. All references will be to ERISA sections embodied as the Pension Reform Act and codified in scattered sections of 29 U.S.C. and to INT. REV. CODE OF 1954, 26 U.S.C., as modified by Title II of ERISA and codified in 26 U.S.C. when applicable.

The enactment of ERISA has generated a great deal of comment from a variety of sources. A review of reference materials on topics, both current and timeless, appeared in Judd and Tracy, *Sources on the New Pension Law*, 53 HARV. BUS. REV. 36 (1975). Those sources worth noting are:

A. Loose Leaf Reporting Services:

1. PENSION PLAN GUIDE (Commerce Clearing House) is a six-volume service that is updated weekly and provides a topical survey of pension and employee benefit law as well as a quick appraisal of new developments.
2. PENSION AND PROFIT SHARING (Prentice-Hall, Inc.) consists of three volumes updated weekly and similar to CCH.
3. BNA PENSION REPORTER (Bureau of National Affairs, Inc.) is a 35-40 page newsletter with materials similar to CCH and Prentice Hall. This service is new since the passage of ERISA.

B. Handbooks on the Pension Law:

1. HANDBOOK ON PENSION REFORM LAW (Prentice-Hall, Inc.) which summarizes the text of the Act and rearranges it by subjects. The book is interpretive and contains examples and guides in each of its sections.
2. HIGHLIGHTS OF THE NEW PENSION REFORM LAW (Bureau of National Affairs, Inc.) provides the text of the law, a brief explanation and includes the Joint Senate and House Conference Committee Reports.
3. PENSION REFORM ACT OF 1974 (Commerce Clearing House) is essentially the same as the BNA booklet.

C. Periodicals that concentrate directly on pension systems and management:

1. PENSION AND WELFARE NEWS (now PENSION WORLD) (monthly).
2. PENSION AND PROFIT SHARING TAX JOURNAL (monthly).
3. INSTITUTIONAL INVESTOR (monthly).
4. PENSIONS AND INVESTMENTS (weekly).

Also contributing timely articles in this area are two publications worth mentioning: TRUSTS AND ESTATES and REAL PROPERTY, PROBATE AND TRUST J.

2. Congressional consideration generally came into focus in 1965 following the issuance of PUBLIC POLICY AND PRIVATE PENSION PROGRAMS - A REPORT TO THE PRESIDENT ON PRIVATE EMPLOYEE RETIREMENT PLANS (1965), by the President's Committee on Corporate Pension Funds and other Private Retirement and Welfare Programs. The *Forward and Summary of Major Conclusions and Recommendations* can be found in P-H PENSION AND PROFIT SHARING ¶¶ 15,012, 15,021 (1970) [hereinafter cited as PRESIDENTIAL COMMISSION REPORT].

In his 1962 Economic Report, President Kennedy commented:

It is time for a reappraisal of legislation governing these programs. They have become, in recent years, a major custodian of individual savings and an important source of funds for capital markets. . . . there is also need for a review of rules

plexity is as impressive as any ever promulgated by the Congress, and whose impact is at once both diverse and inestimable. Most importantly, the Act brought into focus for the first time the term "fiduciary responsibility,"³ and created a "prudent man" standard⁴ designed to regulate the activities of all broadly-defined fiduciaries:⁵ those who have discretionary authority in the administration of pension and welfare plans and those involved in dealing with plans held in trust. The prominence of this term in the Act reflects the overall intent to correct through regulation the inadequate and inequitable distribution of interests in private pension and welfare plans⁶ and "assure workers that pension plans do furnish them with meaningful benefits" and are not merely ". . . a phantom for millions of workers who now never collect them."⁷

An examination of the private pension system leads the alert legal critic through a course of study that embodies broad areas of labor

governing the investment policies of these funds and the effects on equity and efficiency of the tax privileges accorded them.

The President directed his committee to conduct "a review of the implications of the growing retirement and welfare funds for the financial structure of the economy," and to consider how the role and character of the private pension system could contribute more effectively to "efficient manpower utilization and mobility." *Id.* at ¶ 15,022.

A major role in bringing the problem of the private pension system to the public was played by the airing on September 12, 1972 of "Pensions; The Broken Promise," by the National Broadcasting Company. See also R. NADER & K. BLACKWELL, *YOU AND YOUR PENSION* (1973).

3. ERISA tit. I, pt. 4; 88 Stat. 874 (1974) [hereinafter cited as ERISA].

4. ERISA § 404(a)(1), which states in part:

. . . a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and

(A) for the exclusive purpose of:

- (i) providing benefits to participants and their beneficiaries; and
- (ii) defraying reasonable expenses of administering the plan;

(B) 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 . . .

5. ERISA § 3(21)(A), which provides in relevant part that:

. . . a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.

But see LAB. DEPT. INTER. BULL. 75-5, June 24, 1975 (*Labor Department Questions and Answers on Fiduciary Responsibility*).

6. ERISA §§ 2(a),(c) (Findings and Declaration of Policy).

7. See *Hearings Before the Subcomm. on the Examination of Private Welfare and Pension Plans of the Senate Comm. on Labor and Public Welfare*, 92nd Cong., 1st Sess., pt. 1, at 1 (1971) (remarks of Senator Harrison A. Williams, Jr., Chairman) [hereinafter cited as *Senate Hearings*].

law,⁸ trusts,⁹ taxation,¹⁰ and contract theory.¹¹ The portrait of the system that ultimately emerges exemplifies what Yale Professor

8. See *Inland Steel Co. v. NLRB*, 170 F.2d 247 (7th Cir. 1948), *cert. denied*, 336 U.S. 960 (1949), where the district court firmly established that retirement plans fall within the scope of wages as defined by the National Labor Relations Act. Thus, an employer may not refuse to bargain over retirement plan administration. See also Note, *Pension Plans and the Rights of the Retired Worker*, 70 COLUM. L. REV. 909, 911-16 (1970); Ziskind, *The Law of Employee Benefit Plans*, 1955 WASH. U.L.Q. 112, 126-38. For further discussion, see note 17 *infra*.

9. The creation of employee benefit trusts following the Revenue Act of 1916, 39 Stat. 756, was an attempt by corporations to avoid difficulties in creating a totally separate fund over which the corporation had little control, and thus reduce taxation. See *Sears, Roebuck & Co. Employees' Savings and Profit-Sharing Pension Fund v. Commr.*, 45 F.2d 506 (7th Cir. 1930), holding that the fund established by the company with five trustees who were directors and employees of the company was taxable.

Following the Revenue Act of 1921, 42 Stat. 227, trusts "created by an employer as a part of a stock bonus or profit sharing plan for the exclusive benefit of some or all of his employees," were tax exempt. Revenue Act of 1921, ch. 136, tit. II, pt. II, § 219(f). The Revenue Act of 1926, ch. 27, § 219(f), 44 Stat. 723, extended this exemption to pension trusts.

See generally Chadwick and Foster, *Federal Regulation of Retirement Plans: The Quest for Parity*, 28 VAND. L. REV. 641 (1975) [hereinafter cited as Chadwick and Foster].

10. Tax advantages are a key to employer involvement in employee benefit trusts. A qualified employee benefit trust created under section 401(a) of INT. REV. CODE of 1954, creates tax benefits in three areas: (1) the employer benefits by deducting his contribution to the plan during the current taxable year even though the employee will not inure any benefits until some point in the future; (2) the employee benefits by not having to report the employer's contribution during the current year. He only pays taxes when the benefits are paid to him, and he will receive favorable capital gains tax treatment for lump sums. See ERISA § 2005, amending INT. REV. CODE § 402(e). See generally Cain, *et al*, *The Pension Reform Act of 1974: Taxation of Distributions*, TAX ADVISER, Jan., 1976, at 32; (3) the trust itself benefits because the income of the trust is not taxable.

An employee benefit plan (pension, profit sharing or stock bonus) will qualify under INT. REV. CODE § 401(a) when: (1) the plan is established and maintained by the employer for the exclusive benefit of his employees or their beneficiaries; (2) the purpose of the plan is to provide a share of profits or retirement income; (3) the contributions or benefits under the plan do not discriminate in favor of officers, shareholders, supervisors or higher paid employees; (4) the plan is permanent; (5) the plan is in writing; (6) the plan is communicated to the employees; and (7) the plan is funded. See Rev. Rul. 69-421, 1969 INT. REV. BULL. No. 32. See also note 9 *supra* and note 16 *infra*; T.I.R. 1416, P-H PENSION AND PROFIT SHARING ¶ 201 (Special Reliance Procedure for Qualifying Employee Benefit Plans).

11. Unless the retirement plan is negotiated, the employee could not, prior to ERISA, enforce pension claims against the employer. Nearly all pension plans reserved to the employer the right to terminate the plan at any time. See McGill, *Public and Private Pension Plans*, in PENSIONS: PROBLEMS AND TRENDS 27, 43 (D. McGill ed. 1955); Note, *Legal Problems of Private Pension Plans*, 70 HARV. L. REV. 490, 496-97 (1957). To recover benefits, disappointed participants were required to: seek remedies through agreements based on the employer-employee contract (determined in part on the employer's good faith); make a strong argument of promissory estoppel; argue that such benefits are deferred wages that have been constructively withheld; or argue under a third party beneficiary theory tied to the employer-employee contract. See Note, *Pension Plans and the Rights of the Retired Worker*, 70 COLUM. L. REV. 909, 917-21 (1970); Note, *Legal Problems of Private Pension Plans*, 70 HARV. L. REV. 490, 494 (1957). See also *Inland Steel Co. v. NLRB*, 170 F.2d 247 (7th Cir. 1948), *cert. denied*, 336 U.S. 960 (1949). See generally Goetz, *Pension Plans and Labor Law*, 1967 U. ILL. L.F. 738.

David Trubek would recognize as a problematic area of the law, too often examined in terms of practicality, while demanding a disciplined inquiry into the relationship between law and social life.¹² It is the intention of this article to examine the new Pension Law through the interdisciplinary approach suggested by Professor Trubek. The Pension Reform Act is an attempt to solve a social problem, and it is incumbent upon those who will enforce their rights under this law to understand the basic theories from which the law derives. Fiduciary responsibility is the essence of the Pension Reform Act, and can be properly viewed as a duty created and enforced by the power of the state to protect the legal system of private pension rights.¹³

This article begins by briefly setting forth the new requirements created by the Pension Law, with particular emphasis of fiduciary responsibility provisions. Necessary to the discussion of fiduciary responsibility is an understanding of the Act's prudent man requirement and the common law philosophy embodied in that rule. Prudence is the issue upon which fiduciary liability will turn, and hence it must be viewed in light of the legislative purpose underlying its enactment. Finally, this article analyzes the enforcement of fiduciary responsibility in terms of economic efficiency and social cost as related to public policy considerations.¹⁴ Thus, this article will primarily enunciate the principle of prudence as it directs all activities of the individual or collective fiduciaries whose responsibilities and duties, as intended in the Act, are subject to a higher standard of diligence and care in an economic sphere so vividly affected by the public interest.

12. See generally Trubek, *Toward a Social Theory of Law: An Essay on the Study of Law and Development*, 82 YALE L.J. 1 (1972) [hereinafter cited as Trubek].

It is now necessary to frame explicit and concise questions on the relationship between law and social life, and to answer these questions by disciplined inquiry. Since the implicit, a priori conclusions about the role of law are no longer valid, we must turn to systematic efforts to understand the relationship among the legal, social, economic, and political orders.

Id. at 1.

13. Cf. Trubek, *supra* note 12, at 32.

Underlying contract in market economies is a legal system of private rights. The essence of this system is that the individual is free to invoke (or not to invoke) the coercive power of the state to enforce duties created by legal rules.

14. To render this analysis in an effective and contemporary manner, the author has relied on R. POSNER, *ECONOMIC ANALYSIS OF LAW* (1972), which is discussed in greater detail in the text accompanying notes 113-125 *infra*. For the classic introduction to social cost and the theory of "transaction costs" see Coase, *The Problem of Social Cost*, 3 J. LAW & ECON. 1 (1960). See also Trubek, *supra* note 12, at 25-28.

THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

Minimum Requirements

The conscious concern for old age security in America is indicative of the American worker's concern for the quality of life and the expectations of the times. Since World War II this social and economic concern has resulted in the dynamic asset growth necessary to meet those expectations, and "... has placed the private pension system in a position to influence the level of savings, the operation of our capital markets, and the relative financial security of millions of consumers, three of the fundamental elements of our national security."¹⁵ ERISA is the most significant piece of legislation ever produced by Congress to regulate the private pension system, and is a response to the need for comprehensive tax¹⁶ and labor¹⁷ guidelines specifically interwoven to guarantee the protec-

15. See H.R. REP. NO. 533, 93rd Cong., 1st Sess. 2 (1973). This report accompanies H.R. 2, 93rd Cong., 1st Sess. (1973) as Supplemental, Additional and Individual Views of the House Education and Labor Committee. H.R. 2 was subsequently combined with other proposed bills to create ERISA. See also, D. MCGILL, FUNDAMENTALS OF PRIVATE PENSIONS 3, 4 (3d ed. 1975) [hereinafter cited as MCGILL].

16. The regulation of employee benefit plans by taxation began with the Revenue Act of 1942, amending the INT. REV. CODE OF 1939. See INT. REV. CODE OF 1939, ch. 1, § 165, 53 Stat. 67, as amended, Revenue Act of 1942, ch. 619, § 162(a), 56 Stat. 862. This Act required, among other things, a classification test for coverage of employees regardless of compensation and a reasonability test for employer deduction of contributions. A tax exemption was granted on the accumulation of income in the trust, and capital gains treatment of lump sum distributions was allowed.

The INT. REV. CODE OF 1954, ch. 1, § 401 *et seq.*, created the loss of tax exempt status when the plan engaged in certain "prohibited transactions," that included a loan of plan assets to the employee without adequate security and reasonable interest. See Chadwick and Foster, *supra* note 9, for an excellent study of tax regulation of retirement plans culminating in ERISA, which still leaves the question of true parity open.

All of these regulatory acts created only safeguards against discrimination and employer fraud, but provided little protection against arbitrary discretion regarding participation rules or fiduciary conduct. For further discussion, see notes 9 and 10 *supra*.

17. The regulation of employee benefit plans by the Labor Department was initiated by the Welfare and Pension Plans Disclosure Act of 1958, Pub. L. No. 85-836, 72 Stat. 997, repealed, ERISA § 111(a)(1), 29 U.S.C. 1031, as amended, ERISA § 111(a)(2). The Act required the registration, reporting, and disclosure to participants and beneficiaries of employee benefit plans of financial and descriptive information related to such plans, and required an annual report specifying contributions and assets filed with the Secretary of Labor by plans with more than 100 participants. *Id.* §§ 5-7. This Act was strengthened by the Welfare and Pension Plans Disclosure Act Amendments of 1962, 18 U.S.C. §§ 664 and 1027 (1970), which conferred certain investigatory and enforcement powers upon the Secretary of Labor, authorizing him to issue written interpretations, provide for bonding of certain persons handling plan assets, and declared theft, embezzlement, false statements, kickbacks and bribery with respect to plans subject to the Act federal crimes. *Id.* §§ 9, 12, 13.

The general theory of these regulations was that by reporting of information concerning plan operations to participants, these dealers would be subject to public scrutiny and participants would be assured proper administration. But experience showed that such information

tion of employee benefit rights. The spirit of this combination is to remedy the inequities in a system beset not by widespread fraud, theft or criminal activity, but by a traditional millstone of strict and arbitrary participation requirements which all too often had no genuine relation to the realities of an employee's actual working life.¹⁸ The Act is primarily designed to prevent any potential abuses of fiduciary discretion in the administration and investment of employee benefit plans.

Congressional investigation determined that private benefit plans were not meeting their commitments because of five dissonant areas of benefit plan administration:¹⁹ the failure of plans to provide necessary minimum and adequate vesting provisions; inadequate plan disclosure and reporting both to participants and to government regulatory agencies; insufficiency of sound and adequate funding to meet the eventuality of accrued benefit payments; premature and arbitrary plan termination without adequate safeguards to protect the vested interest of plan participants; and finally, ineffective and informal fiduciary responsibility requirements that not only threatened the safety and preservation of the capital assets of the pension trust corpus,²⁰ but also lacked the effectiveness to protect the interests of workers in regard to such plans through principles of prudent fiduciary conduct.

The provisions in the Pension Reform Act concerning participation and vesting²¹ are a response by Congress to the inability of the private pension system to provide a guaranteed retirement benefit

was insufficient and that employee policing was ineffective. This theory ignored the problems of participation requirements and fiduciary responsibility. See H.R. REP. NO. 533, 93rd Cong., 1st Sess. 11 (1973). For further discussion, see note 8 *supra*.

18. See *Senate Hearings*, *supra* note 7, at 12 (statement of Senator Jacob K. Javits).

19. See *Senate Hearings*, *supra* note 7, at 2.

20. "Fiduciary" is an offspring of trust law and is one normally occupying a position of confidence or trust with regard to the trust and its beneficiaries. Some retirement plans are not funded through traditional trust vehicles, *e.g.*, insured group annuity contracts, but persons who have discretionary control over these plans are equally responsible under the standards of a fiduciary. H.R. REP. NO. 533, 93rd Cong., 1st Sess., 11-12 (1973). See discussion accompanying notes 42 through 85 *infra*.

21. See ERISA §§ 201, 202, 1011 and 1013, INT. REV. CODE §§ 410, 414(b) and (c) (participation); ERISA §§ 201, 203, 204 and 1012(a), INT. REV. CODE § 411 (vesting). See also T.I.R.-1334, P-H PENSION AND PROFIT SHARING ¶ 107,026 and T.I.R.-1403, P-H PENSION AND PROFIT SHARING ¶ 107,097. These Technical Information Releases deal with specific questions relating to qualification and aid in clarifying the rules with examples of plan provisions that meet or fail to meet the requirements. Detailed rules and regulations for minimum standards in employee benefit plans which provide methods for computing service to be credited to an employee including years of service, hours of service, years of participation and breaks in service can be found at 40 Fed. Reg. 41654 (1975). See also Treas. Temp. Reg. § 11.410, 40 Fed. Reg. 45812 (1975).

and to prevent the all too frequent loss of accumulated pension benefits because of job termination or sudden layoff.²² Within its cumbersome constrictions the Act provides a detailed and intricate set of rules that define minimum effective dates for participation in an employee benefit plan.²³ The minimum standards of participation vastly increase the number of employees covered by qualified retirement plans and significantly alter the financial obligations of employer-sponsors.²⁴

The minimum vesting rules are designed to more reasonably equate years of service with benefits earned, and eliminate the arbitrary discrimination evidenced by grossly inadequate grading formulas. The vesting rules require that employer contributions must vest at least as fast as provided by one of three alternative schedules,²⁵ and have created nonforfeitable rights to benefits in substan-

22. In a congressional study of 87 plans representing \$16 billion in assets and some 9.8 million workers participating since 1950, only 5 percent of all participants who left since 1950 in 51 pension plans with 11 or more years for vesting have received a benefit, and only 16 percent of all participants who left since 1950 in 36 plans with ten years for vesting have received a benefit. In terms of forfeitures, 92 percent of all active participants since 1950 who left the 51 plans forfeited without qualifying for benefits. See *Senate Hearings*, *supra* note 7, at 365-66.

23. Under the Act, the minimum age of participation can be no greater than 25, with at least one year of service to the employer. ERISA §§ 202(a)(1)(A), 1011(a)(1)(A), INT. REV. CODE § 410(a)(1)(A). For the definition of "years of service," see ERISA §§ 202(a)(3)(A), 1011(a)(3)(A), INT. REV. CODE § 410(a)(3)(A). "Hours of service" is an important measurement for both participation and vesting clocks. See Proposed Lab. Dept. Reg. § 2530.200-204, 40 Fed. Reg. 41654 (1975) for minimum standards proposed by the Department of Labor. See also Treas. Temp. Reg. §§ 11.411(a)-1 to 9; Treas. Temp. Reg. §§ 11.410(a)-1 to 6, (b)-1 (1975).

Cf. ERISA §§ 202(a)(1)(B)(i), 1011(a)(1)(B)(i), INT. REV. CODE § 410(a)(1)(B)(i); ERISA § 1011(b)(1), INT. REV. CODE § 410(b)(1).

24. The costs of vesting pensions are expected to range from 0 to 1.5 percent of payroll, which, if a corporation's pension plan now costs 7.5 percent of payroll-the approximate national average-an increase in 1.5 percent means a 20 percent increase in pension costs. See Patocka, *The Pension World Reacts to the New Legislation*, INSTITUTIONAL INVESTOR, Nov. 1974, at 81, 92. The freedom which companies enjoyed before the Act to set their own vesting schedules "enabled many companies that otherwise could not have afforded to do so to set up pension plans for their older, long-term employees." *Pension Reform's Expensive Richochet*, BUSINESS WEEK, March 24, 1975, at 144, 150. See also Gunn, *Participation and Vesting Under the Employee Retirement Income Security Act of 1974*, 1975 U. ILL. L.F. 181, 195, n.61 [hereinafter cited as Gunn].

25. See ERISA §§ 203(a)(2)(A),(B),(C), 1012(a)(2)(A),(B),(C), INT. REV. CODE §§ 411(a)(2)(A),(B),(C).

See also ERISA §§ 203(a)(2)(C)(ii), 1012(a)(2)(C)(ii), INT. REV. CODE § 411(a)(2)(C)(ii); H.R. REP. NO. 533, 93rd Cong., 1st Sess. 14 (1973).

Highly mobile employees can be provided with faster vesting within the restrictions of ERISA § 1012(b), INT. REV. CODE § 401(a)(5); see ERISA § 1012(d)(1), INT. REV. CODE § 411(d)(1); Chadwick and Foster, *supra* note 9, at 673.

Certain special rules apply to collectively-bargained and multi-employer benefit plans. For

tially younger members of the work force.²⁶

The value of benefits accumulated during the period of participation is determined in a profit sharing or defined contribution plan by the balance in the individual participant's account. In a pension or defined benefit plan the value is determined by the accrued benefit formula contained within the plan provisions, which must now be structured in such a way to avoid "backloading"—attributing disproportionately greater benefits in later years of service,—thereby discriminately favoring employees with longer periods of service.²⁷

It should be readily apparent that the participation and vesting standards created by the Pension Reform Act go a long way toward rationally conforming work service with retirement benefits. The measure of its success should not be in terms of extraordinary benefits at retirement,²⁸ but simply a realistic expectation among today's employees of future retirement income.

Correlated with the need for broader coverage and guaranteed rights in corporate pension plans is the need to cover those individuals who are either not covered by a plan because they are self-employed and unincorporated, or those whose employers simply do not sponsor private retirement plans.²⁹ The Act responds to this need by raising the permitted deductions allowed for Self-Employed Retirement plans³⁰ and by establishing similar, though smaller de-

an excellent discussion of these considerations see Berger and Hester, *Effect of ERISA on Multi-Employer Plans: Participation, Vesting, Accrual of Benefits*, 43 J. TAX 82 (1975).

26. See PRESIDENTIAL COMMISSION REPORT, *supra* note 2, at ¶ 15,012.5-.6; Gordon, *Q's and A's of Vesting*, FINANCIAL EXECUTIVE, June, 1975, at 44, 48.

27. ERISA §§ 204, 1012(a)(7), INT. REV. CODE § 411(a)(7). The Act provides three alternative benefit accrual methods. See ERISA §§ 204(b)(1)(A),(B),(C), 1012(b)(1)(A),(B),(C), INT. REV. CODE § 411(b)(1)(A),(B),(C); Gunn, *supra* note 24, at 186-88. See also Proposed Lab. Dept. Reg. § 2530.200b-1(a), 40 Fed. Reg. 174 (1975).

28. It has been noted that the major problem of retirement income planning today is how to provide adequate retirement income at manageable cost in an inflationary economy. Gunn, *supra* note 24, at 196-97.

29. The Act, however, does not cover all private retirement plans. The Act specifically excludes: governmental plans; church plans not covered by INT. REV. CODE § 410(d); plans maintained solely for workmen's compensation, unemployment compensation or disability insurance; plans maintained outside of the United States for persons who are non-resident aliens; and any excess benefit plans provided by an employer solely for providing excess benefits for certain employees. ERISA § 4(b). But see H.R. REP. NO. 533, 93rd Cong., 1st Sess. 43-44 (1973) (additional views of Representative John N. Erlenborn).

30. ERISA § 2001(a), INT. REV. CODE § 404(e). See Goetz, *Income Tax Aspects of the New Pension Reform Law*, 1975 U. ILL. L.F. 143, 150-56 [hereinafter cited as Goetz]; Chadwick and Foster, *supra* note 9, at 658-65. See also ERISA § 2001(b), INT. REV. CODE § 1379(b)(1). See Irish, *Impact of the New Pension Law on H.R. 10 and Subchapter S Retirement Plans*, 43 J. TAX., 144 (1975); Zalutsky, *An Analysis of the Post-ERISA Advantages of Incorporation for the Professional*, 43 J. TAX. 240 (1975).

ductions, for individuals who establish their own retirement trusts when they are not covered by their employer.³¹ Lump-sum tax advantages are also sweetened by the Act for those who retire with a lump-sum withdrawal of their retirement savings.³²

Since the passage of the Welfare and Pension Plans Disclosure Act,³³ the underlying assumption of pension benefit reformers has been that the reporting of generalized information concerning a plan's operation would, because it subjected such records to public scrutiny, insure that the plan would be operated in the best interest of the participants.³⁴ Thus, the inadequacies of such ineffective enforcement were overlooked by employers who were concerned with the more intangible requirements proposed for participation, vesting and funding.³⁵ Experience showed, however, that more particularized reporting was needed to show the participant where he stands in respect to a plan, so that he can readily understand what benefits he is entitled to, the circumstances that could preclude receipt of those benefits, the requirements he must meet to become eligible for those benefits, and the financial stability of plan assets held in trust for him.

Under Titles I and II of the Pension Reform Act, which are applicable to all pension and welfare plans,³⁶ detailed requirements for informing plan participants of their rights and benefits and for reporting annual statements to the government, have been explicitly defined.³⁷ The failure of a plan administrator to comply with these

31. ERISA § 2002(a), INT. REV. CODE § 219. See Stevenson, *The New Individual Retirement Accounts: What They are and How They Operate*, 43 J. TAX. 91 (1975).

32. ERISA § 2005, INT. REV. CODE § 402(e). See Kopple and Veenhuis, *An Analysis of Lump Sum Distributions After the Pension Reform Legislation*, 43 J. TAX. 2 (1975); Goetz, *supra* note 30, at 157-63.

33. For further discussion, see note 17 *supra*.

34. H.R. REP. NO. 533, 93rd Cong., 1st Sess. 11 (1975). The Secretary of Labor's role in the enforcement scheme was minimal, and the belief that pension plan participants would police their own plans proved to be obviously fallacious.

35. See Patocka, *The Pension World Reacts to the New Legislation*, INSTITUTIONAL INVESTOR, Nov. 1974, at 83. Some 1.8 million plans could conceivably be affected by the reporting requirements.

36. Under ERISA § 104(a)(3), certain reporting and disclosure requirements of employee welfare benefit plans are deferred. Proposed Lab. Dept. Reg. Part 2520.104-20, 40 Fed. Reg. 34526 (1975). (Rules and Regulations for Reporting and Disclosure) allows a limited exemption from reporting and disclosure requirements for welfare benefit plans with fewer than 100 participants.

37. See generally ERISA §§ 102-11, 209, 1022, 1031-34, 3041-43, INT. REV. CODE §§ 6057-59; Proposed Lab. Dept. Reg. Part 2520, 40 Fed. Reg. 34526 (1975). See also Proposed Treas. Reg., Form 5500 (Annual Report), 40 Fed. Reg. 45134 (1975); Proposed Lab. Dept. Reg., Plan Description, 40 Fed. Reg. 48096 (1975); 29 C.F.R. §§ 2520.103-0 to 103-7; 104-40 to 104-45; 104a-5 to 6; 104b-10 to 11; 40 Fed. Reg. 53710 (1975) (Annual Reporting Requirements).

requirements can subject him to both criminal and civil penalties.³⁸

Finally, the Act creates minimum funding standards for defined benefit or pension plans designed to reduce the unnecessary exposure to risks of premature termination of plans because of inadequate funding.³⁹ The rights created under the participation and vesting standards would be meaningless if there were insufficient funds to pay accrued benefits at retirement. "The vesting standards may be viewed as controlling the volume of the benefit promises made by the plan and the funding provisions as controlling the quality of those promises."⁴⁰ The benefit in a pension plan is now guaranteed to some extent by the government through the creation of a federal insurance agency, the Pension Benefit Guaranty Corporation, which is funded by premiums based upon a tax per participant imposed on either the plan or the employer.⁴¹

Fiduciary Responsibility—Overview

The development of the private pension system has been the result of business and labor initiative. Public policy has encouraged and protected retirement plans through tax laws, labor relations statutes and standards of fiduciary responsibility inherent in the

38. The civil enforcement sections of the Act provide for the initiation of action by plan participants and their beneficiaries, who may be joined by either the Secretary of Labor or Treasury. See, e.g., ERISA §§ 1031(b), 501, 502, INT. REV. CODE § 6652(e), (f).

39. An actuarial funding statement is required as an attachment to the annual report. ERISA §§ 103(a)(4)(A), 1033(a), INT. REV. CODE § 6059. Such statement must be filed by an "enrolled actuary," defined under ERISA tit. III, subtit. C §§ 3041-43, INT. REV. CODE § 7701(a)(35), which authorizes the creation of a Joint Board for the Enrollment of Actuaries to establish standards for actuaries performing services with respect to pension and welfare plans. Under such enrollment, which will be subject to the duties prescribed under the Act, the actuary is obligated in the future to perform his duties with greater independence, particularly from the plan employer. See Mueller, *What Practitioners Should Know About the Expanded Role of the Actuary Under ERISA*, 43 J. TAX 149 (1975). The Joint Board issued proposed regulations for pre-1976 enrollment of actuaries requiring an appropriate period of responsible actuarial experience. 40 Fed. Reg. 20326 (1975).

40. H.R. REP. NO. 533, 93rd Cong., 1st Sess. 14 (1973). See MCGILL, *supra* note 15, at 62-63. Many plans have become underfunded as benefits have expanded, increasing "prior service costs" or "unfunded liabilities." These have placed a heavy drain on corporate profits, and will continue to do so under ERISA. See Faltermayer, *A Steeper Climb Up Pension Mountain*, FORTUNE, Jan. 1975, at 78, 157; MCGILL, *supra* note 15, at 332-62. Acceptable funding methods have been defined in the Act. ERISA § 3(31). See also *Pension Reform's Expensive Ricochet*, BUSINESS WEEK, Mar. 24, 1975, at 150; *The Big Pension Fund Drain*, DUN'S REVIEW, July, 1975, at 31. Plans must now amortize the unfunded liabilities, which are offset by experience gains and losses in fund investments. ERISA §§ 302(b), (c), 305, 1031(b), (c), (g), INT. REV. CODE §§ 412(b), (c), (g). See also ERISA § 1013(a), INT. REV. CODE § 4971 which imposes taxes on accumulated funding deficiencies when not corrected within a 90-day "correction period" following notice.

41. ERISA tit. IV, 29 U.S.C. §§ 1301 *et seq.* See Proposed Reg. on Notice of Intent to Terminate Pension Plans, 40 Fed. Reg. 29555 (1975).

body of trust law.⁴² The Pension Reform Act significantly expands this protection by assuring workers that long-awaited retirement benefits will be paid by virtue of strict vesting and funding standards.

Fiduciaries occupy positions of confidence and trust in regard to the control, management and disposition of plan assets, including the administration of the plan itself when it involves discretionary authority. Prior to the enactment of the Pension Reform Act duties of fiduciaries were defined by the common law of trusts. The fiduciary responsibility section of the Act⁴³ codifies and makes applicable to all plan fiduciaries certain principles evolved in the law of trusts.⁴⁴ The law was codified within the Act because traditional trust law was frequently inapplicable to a number of plans, particularly those funded as insured plans. Also, traditional trust law does not adequately protect the interests of plan participants and beneficiaries, because trust law developed in the context of testamentary and *inter vivos* trusts designed to pass the corpus to an individual or small group of beneficiaries with the intended emphasis of carrying out the instructions of the settlor. These rules have been applied to corporate pension plans where the sponsor alleviated the trustee of most duties through the engagement of exculpatory language in the trust instrument.⁴⁵

The codification of uniform duties of responsibility which clearly set up standards of conduct measurable by the courts, facilitates active enforcement of those duties by plan participants. Furthermore, such a uniform standard cuts across state boundaries to eliminate divergent measurements of responsibility,⁴⁶ and enables the courts to interpret the fiduciary standards "bearing in mind the special nature and purposes of employee benefit plans intended to be effectuated by" the Pension Reform Act.⁴⁷

A fiduciary is defined very broadly in the Act as any person who exercises any discretionary authority or discretionary control respecting the management of a plan, or of the management or disposition of plan assets. One who renders investment advice for a fee or has any discretionary authority over the administration of the

42. See PRESIDENTIAL COMMISSION REPORT, *supra* note 2, at ¶ 15,022.

43. ERISA § 404(a)(1).

44. H.R. REP. NO. 533, 93rd Cong., 1st Sess. 11 (1973).

45. *Id.* at 12. See Friedman, *The Dynastic Trust*, 73 YALE L.J. 547, 548-51 (1964); Lindquist, *Fiduciary Responsibilities of Trustees of Employee Benefit Trusts; The "Trust" Relationship*, 7 REAL PROPERTY, PROBATE AND TRUST J. 775, 776-78 (1972).

46. H.R. REP. NO. 533, 93rd Cong., 1st Sess. 12 (1973).

47. *Id.*

plan is also a fiduciary under the Act.⁴⁸

Basic fiduciary requirements for a plan and trust require that the plan be maintained pursuant to a written instrument, that the instrument provide for one or more "named" fiduciaries, that the assets of the plan be held in trust and that the plan provide procedures for the establishment of fund policy consistent with the objectives of the plan, which must include allocation of duties and the basis on which benefits are paid.⁴⁹

The Act requires that fiduciaries discharge their duties solely in the interest of the participants and beneficiaries of the plan, for the exclusive purpose of providing benefits.⁵⁰ In discharging their duties fiduciaries must adhere to a more stringent, "prudent man" standard,⁵¹ and must correspondingly diversify all assets held in trust, in order to minimize the risk of excessive losses, unless under the circumstances it is clearly prudent not to do so.⁵² Fiduciaries must act in accordance with plan provisions unless such provisions are

48. See ERISA § 3(21), the pertinent text of which is set forth in note 5 *supra*. Such a broad definition does not include, however, an attorney, accountant, actuary or consultant unless, under particular fact situations, the individual exercises some measure of discretion or control as defined in the Act. See LAB. DEPT. INTER. BULL. 75-5, June 24, 1975. Persons who perform purely ministerial functions such as the application of rules determining eligibility, calculation of service and compensation credits or the preparation of reports for the government, when they have no power to make any decisions as to plan policy, interpretations, practices or procedures, are not fiduciaries. See LAB. DEPT. INTER. BULL. 75-8, Oct. 6, 1975. Positions of administrative authority within the plan should be examined to determine whether there is any discretionary authority as described by the Act. Members of the board of directors of the employer would be fiduciaries if they were responsible for the selection and retention of plan fiduciaries, but are not responsible for co-fiduciary breaches if a fiduciary should breach his duty arising from ERISA § 405(a). *Id.*

An additional question is raised with regard to the individuals employed by the fiduciary entity responsible for an employee benefit plan. Only the entity itself, it is contended, should be considered a fiduciary, and not individuals employed by the entity. This is in accordance with traditional legal treatment of corporations and their employees. See Letter from the Corporate Fiduciaries Association of Illinois to Steven Sacher, Assoc. Solicitor, Dept. of Labor, Jan. 23, 1975 (copy on file at Loyola University of Chicago Law Journal Office). The interpretation of this question is important to corporate indemnification. The Labor Department implied its agreement in principle by allowing indemnification of a plan fiduciary's employees who actually perform the fiduciary's services. See LAB. DEPT. INTER. BULL. 75-4, June 4, 1975.

49. ERISA §§ 402(a),(b).

A "named fiduciary" is a fiduciary named in the instrument who has authority to control and manage the operation and administration of the plan. ERISA §§ 402(a)(1), (2).

Insurance assets need not be held in trust. Oppenheimer, *Fiduciary Responsibility, Reporting and Disclosure Under the New U.S. Pension Law*, THE TAX EXECUTIVE, Jan., 1975, at 109.

50. ERISA § 404(a)(1)(A). Fiduciaries must also defray reasonable expenses of administering the plan.

51. ERISA § 404(a)(1)(B). The "prudent man" rule in trust law is discussed more fully in the text accompanying notes 86 through 96 *infra*.

52. ERISA § 404(a)(1)(C).

inconsistent with the Act.⁵³ Also, as under former Code provisions,⁵⁴ fiduciaries are prohibited from dealing with "parties in interest" or "disqualified persons."⁵⁵

These prohibited transaction provisions have created the greatest amount of controversy. The general prohibition in the Act is against business and investment transactions between the plan and parties in interest.⁵⁶

Questions arise, quite obviously, as to what constitutes a party in interest within the realities of market transactions which occur each day in private pension funds.⁵⁷ Frequently, close relationships with broker-dealers create what is, in effect, a transaction with a party in interest, particularly when the broker-dealer is engaged in services to the plan that extend beyond the simple trading of securities. An exemption for transactions with broker-dealers has been extended by the Secretary of the Treasury.⁵⁸ An additional issue has arisen regarding research services provided by broker-dealers, who normally provide such services to the plan under an arrangement that involves direction by the plan administrator that brokerage be placed through the particular broker-dealer providing the research service to offset the service fees. Because of the ban on fixed-commission rates, trustees must seek the "best execution" when handling security trades for portfolios under their management, acting solely with the interests of the plan and its participants in

53. *Id.* § 404(a)(1)(D).

54. See INT. REV. CODE §§ 401 *et seq.*

55. ERISA §§ 406, 2003(a), INT. REV. CODE § 4975.

56. Under the law a party in interest includes a plan administrator, officer, fiduciary, trustee, custodian, counsel or employee; a person providing services to the plan; the employer, its employees, officers, directors, and 10 percent shareholders; controlling or controlled parties or parties under common control; employer organizations with members covered by the plan, its officers, directors and affiliates; and certain relatives and partners of parties in interest. See ERISA § 2003(e)(2), INT. REV. CODE § 4975(e)(2); MCGILL, *supra* note 15, at 56.

A fiduciary with respect to a plan shall not cause the plan to engage in a transaction that involves the sale or exchange or any property between the plan and a party in interest, nor use the assets of the plan in any way that is not within the interest of plan participants or inures to any other benefit than to the plan. ERISA §§ 406(a)(1), (2), 2003(c)(1), INT. REV. CODE § 4975(c)(1).

The law does list, however, several exemptions from these rules and other administrative variances for transactions that are in accord with established business practices and provide safeguards to the plan and its participants. ERISA §§ 408(c)(2), (d), INT. REV. CODE § 4975(c)(2), (d). The exemptions include, *inter alia*, loans for the benefit of plan participants, contracts for life insurance, and ancillary services of the trustee bank.

57. A schedule of each transaction involving a person known to be a party in interest must be included in the annual report. ERISA § 103(b)(3)(D); for further discussion see note 56 *supra*. See generally Neal and Bret, *ERISA Limitations on the Performance of "Multiple Services" by Fiduciaries*, 44 J. TAX 90 (1976).

58. See 40 Fed. Reg. 43785 (1975).

mind.⁵⁹ Thus, trustees are required, under new securities law,⁶⁰ to determine in good faith commissions paid to the directed broker-dealer were reasonable in relation to the services provided. That this is consistent with the requirements of fiduciary responsibility cannot be questioned, but it is sufficiently illustrative of the type of problem that can arise within the definitional framework erected by the Act.

The Pension Reform Act creates a concurrent fiduciary liability for actions of co-fiduciaries.⁶¹ This provision has induced a great deal of consternation among plan fiduciaries who would prefer to remain responsible solely for their own duties. The standard applied is still clearly the "prudent man" standard, which operates to determine the liability of the fiduciary who participates in, or knowingly undertakes to conceal, any act or omission of another fiduciary, with reasonable knowledge that such act or omission is a breach of duty.⁶² He is equally liable if by his failure to conform to the requirements of fiduciary responsibility he enables another fiduciary to commit a breach,⁶³ or if he has knowledge of a breach by another fiduciary, unless he takes reasonable steps to remedy such a breach.⁶⁴

The liability for the breach of a co-fiduciary can be mitigated, and perhaps avoided completely, by employing any of three alternative delegations of responsibility allowed by the Act. The named fiduciary or trustee may allocate specific duties and responsibilities among the co-trustees of a plan through the trust agreement or pursuant to procedures specified in the plan.⁶⁵ If the named fiduciary or trustee acts prudently in implementing such procedures, both fiduciaries are relieved of responsibility for acts or omissions unless they have knowledge of such breach and fail to act reasonably

59. See ERISA § 404(a)(1)(B); Hurlock, *Fiduciary Responsibility and Negotiated Commissions*, 114 TRUSTS & ESTATES 388 (1975). The ban on fixed commission rates became effective on May 1, 1975.

60. S. 249, 94th Cong., 1st Sess. § 20 (1975).

61. ERISA § 405.

62. *Id.* § 405(a)(1).

63. *Id.* § 405(a)(2).

64. *Id.* § 405(a)(3). *E.g.*, when one trustee of a retirement plan opposes the remaining trustees' proposal to invest in a building because he feels it is imprudent, it is not enough that the trustee merely resigns; he must take steps to avoid equal liability with the imprudent trustees. It is advised that such trustee record his objection, and insist that such objection be included in the record of the investment meeting. LAB. DEPT. INTER. BULL. 75-5, June 24, 1975.

65. ERISA §§ 405(a), (c)(2)(A). See Cardon, *Plan Design for Fiduciary Protection*, FINANCIAL EXECUTIVE, July, 1975, at 34, 35; MCGILL, *supra* note 15, at 50-51; Rock, *Fiduciary Responsibility Broadened by Provisions of the Pension Reform Act*, TAX. FOR ACCOUNTANTS, April, 1975, at 205, 207.

in an effort to remedy it. If the plan instrument does not provide for a procedure for the allocation of fiduciary responsibilities among the named fiduciaries, then any allocation the named fiduciaries may make among themselves will be ineffective to relieve the fiduciary of any liabilities incurred because of the breach of a co-fiduciary.⁶⁶ Though the personal liability of a fiduciary is normally limited to the functions which he performs relative to the plan,⁶⁷ he must react to his duty to remedy any breaches of his co-fiduciaries when they become known to him, or should have become known to him, in his capacity. Allocation of those responsibilities merely defines the limits of his own responsibility to the plan, and mitigates his absolute responsibility.

A second alternative delegation is to an investment advisor who determines the holdings of the plan portfolio and assumes the risks of prudent investment management.⁶⁸ The investment advisor must be one defined by the Act,⁶⁹ and he is required to assume the fiduciary responsibilities incumbent upon a plan fiduciary. The named fiduciary would then limit his liability to the prudent designation and retention of the investment advisor.

Finally, a third alternative, practical for only very small plans, is to earmark investment responsibility to the individual participant or beneficiary who exercises control over the assets in his individual account.⁷⁰ The participant assuming such responsibility is specifically exempt from any liability for loss because he would not be considered a fiduciary.⁷¹ This type of discretionary control must be

66. See LAB. DEPT. INTER. BULL 75-8, October 6, 1975.

67. See ERISA § 3 (21)(A).

68. ERISA §§ 402(c)(3), 405(d).

69. An "investment manager" is defined by ERISA § 3(38) as a registered investment adviser, a bank, or an insurance company qualified under the law of more than one state, who has the power to manage, acquire or dispose of any asset of the plan and has acknowledged in writing that he is a fiduciary. The term does not include a trustee or a named fiduciary.

Under the terms of sections 403(a)(2) and 402(c)(3) of the Act, such authority and discretion may be delegated to persons who are investment managers as defined above. Under section 402(c)(2), however, if the plan so provides, a named fiduciary may employ other persons to render advice to him to assist him in carrying out his investment responsibilities. LAB. DEPT. INTER. BULL. 75-8, October 6, 1975. Under ERISA § 3(21)(A)(ii), an investment advisor qualifies as a fiduciary.

The term "trustee responsibility" represents the responsibility provided in a plan's trust instrument to manage or control the plan's assets, and is distinguished from any trust provisions which allow the appointment of an investment manager. ERISA § 405(c)(3).

70. ERISA § 404(c).

71. *Id.* §§ 404(c)(1),(2); See Note, *Fiduciary Standards and the Prudent Man Rule Under the Employment [sic] Retirement Income Security Act of 1974*, 87 HARV. L. REV. 960, 975 (1975) [hereinafter cited as *Fiduciary Standards and Pension Plans*], which opines that the named fiduciary can avoid liability by such an arrangement. Recognizing the inefficiencies

permitted by provisions of the plan, and in itself may be disastrous for the growth of the fund as a whole when such fund is controlled by untrained or unsophisticated plan participants.

Additional fiduciary responsibilities require that the trust document contain a specific statement that plan assets will never inure to the benefit of the employer, but shall be held for the exclusive benefit of the plan participants;⁷² that a plan not hold more than ten percent of its market value in employer securities or property,⁷³ unless the plan is an eligible individual account plan;⁷⁴ and that the fiduciary not deal with plan assets to benefit his own interest.⁷⁵ These provisions are an integral part of the overall regulatory goal of creating a plan for the exclusive benefit of a broad class of employees, with the assets being managed in the interest of, and in a manner that is protective of the rights of plan participants and their beneficiaries.

rampant in such a suggestion, the author posits that the participant be allowed to specify the division of his account between risky and risk-free assets, with the fiduciary being responsible only for selecting the fund assets individually and allocating those assets among the individual accounts of the participants in proportion to their choice of risk. *Id.* at 975-76. Such a suggestion patently ignores the fact that the individual upon whose choice the selection of the assets rests is still a fiduciary under the Act by virtue of his discretion in choosing those assets, and would still be required to invest prudently. Because the participant is not a fiduciary, and because he relies upon the nature of the portfolio chosen, the fiduciary hardly mitigates his liability. For a better understanding of "risk" see note 129 *infra*.

72. ERISA § 403(d). This requirement is reminiscent of the qualification requirement under INT. REV. CODE § 401(a), discussed in note 10 *supra*. Under ERISA this requirement assumes much greater emphasis.

73. ERISA § 407(a). This requirement becomes effective for existing plans after December 31, 1984, and refers to the then market value as of either December 31, 1984 or December 31, 1975, to protect plans which sustain an increase in the value of employer securities or a decrease in other plan assets. At least 50 percent of "qualifying" employer securities and real property must be disposed of by December 31, 1979. *Id.* § 407(a)(3)(A), (4)(A). "Qualifying" employer securities means stock or marketable debt securities of the employer. "Qualifying" employer real property means property leased to the employer, or to an affiliate of such employer. *Id.* § 407(d)(1), (2).

Employee Stock Ownership Plans (ESOPs), which are stock bonus or money purchase pension or stock bonus plans designed to invest solely in qualifying employer securities, are given special treatment under the Act, and are not required to meet the 10 percent test. *Id.* § 407(d)(6). See Lew, *The Facts and Fables of ESOPs*, P-H PENSION AND PROFIT SHARING ¶ 518 (1975).

74. ERISA § 407(b)(1). An "eligible individual account plan" means an individual account plan which is a profit sharing, stock bonus, thrift or savings plan, an employee stock ownership plan or money purchase plan existing at the inception of the Act. *Id.* § 407(d)(3)(A). An individual account plan must specifically provide for such investment in the plan instrument. *Id.* § 407(d)(3)(B).

Such investments in employer securities are always subject to the standard of prudence applicable to all securities. See Haneburg, *Employer Securities Problems Under ERISA*, 114 TRUSTS AND ESTATES 356, 359 (1975).

75. ERISA § 406(b).

Under Title I of the Act, which encompasses those requirements enforced by the Department of Labor, a fiduciary is personally liable for a breach of a fiduciary duty required by the Act,⁷⁶ and must restore to the plan any losses resulting from the breach, or any profits he has made through the use of any plan asset.⁷⁷ Most importantly, the fiduciary shall be subject to such other equitable measures as the court may deem appropriate, including the actual removal of the fiduciary. The action may be brought by the participant, beneficiary or co-fiduciary to enjoin any practice or enforce any requirements enumerated by the Act.⁷⁸ Additional action may be taken by the Secretary of the Treasury by levying an excise tax on prohibited transactions under Titles I and II,⁷⁹ or by the Secretary of Labor in either a criminal action under Title 18 of the *United States Code*, relating to false statements, bribery, kickbacks or embezzlements in connection with retirement plans,⁸⁰ or a civil action for willful violation of fiduciary requirements.⁸¹

The Act specifically provides that a fiduciary may be protected to some degree by purchasing fiduciary liability insurance, or by allowing the plan or plan sponsor to purchase such insurance for him.⁸² A plan can provide such insurance, however, only if the insurer has recourse against the fiduciary for the breach of duty.⁸³ The Act also requires that every person who handles plan funds must be bonded in an amount equal to at least ten percent of the amount of funds handled.⁸⁴ Indemnification by the plan sponsor or employer of the fiduciary may serve as a shield to liability for breaches committed without willful intent.⁸⁵

76. *Id.* § 409(a).

77. *Id.*

78. *Id.* § 502(a). Such actions must be commenced no later than six years after the breach or three years after the plaintiff has actual knowledge of the breach, except in the case of fraud or concealment, whereupon such action may be commenced no later than six years after the discovery of the violation. *Id.* § 413(a).

A plan fiduciary will not be liable, however, with respect to a breach of fiduciary duty if such breach occurred before he became a fiduciary or after he ceased to be a fiduciary, subject to the six year limit above. *Id.* § 409(b).

79. See note 38 *supra*.

80. ERISA § 514(d).

81. *Id.* § 501. The Secretary of Labor has the power to investigate any violations in respect to the Act, and require the presentation of any books or records relevant to the investigation, under the authority of sections 9 and 10 of the Federal Trade Commission Act, 15 U.S.C. §§ 49, 50 (1970), and with regard to insured banks, under the authority of section 3(g) of the Federal Deposit Insurance Act, 12 U.S.C. § 1813 (q) (1970). ERISA § 504.

82. ERISA § 410(b)(2), (3).

83. *Id.* § 410(b)(1),(2).

84. *Id.* § 412(a).

85. See note 38 *supra*.

Prudent Man Rule

The general standard which has controlled fiduciary conduct in the past was the "prudent man rule."⁸⁶ The Pension Reform Act codifies⁸⁷ and extends the prudent man requirement, and states that a fiduciary must act in respect to his duties outlined by the Act, "with care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."⁸⁸ The new statutory rule therefore requires a higher standard of conduct than the common law rule, as the phrase "familiar with such matters" elevates the "prudent man rule" to a "prudent expert rule."⁸⁹

The rule is an extension of the standards expounded by Justice Putnam in the classic case, *Harvard College v. Amory*,⁹⁰ involving a suit by the remainderman of a trust who alleged a breach of responsibility by the trustee for investing in an impermissible security.⁹¹ *Harvard College* established the duties of a trustee for investment by encouraging the exercise of skill, care and caution in the reasonable selection of investment securities.

The "prudent man rule" evolved through a period of legal listing and strict interpretation that included legislation regulating common trust funds and investment companies.⁹² When the trustee failed to invest prudently, and the trust property subsequently dim-

86. See RESTATEMENT (SECOND) OF TRUSTS § 227 (1959); 3 SCOTT, TRUSTS § 227 (3d ed. 1967); BOGERT, TRUSTS & TRUSTEES § 541 (2d ed. 1960); Shattuck, *The Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century*, 12 OHIO ST. L.J. 491 (1951); Smith, TRUSTEES DUTIES REGARDING INVESTMENTS, 4 REAL PROPERTY, PROBATE & TRUST J. 604 (1969). See also *Fiduciary Standards and Pension Plans*, supra note 71, at 965-67; Note, *Trustee Investment Powers: Imprudent Application of the Prudent Man Rule*, 50 NOTRE DAME LAW. 519, 519-22 (1975).

87. A great many states have already codified the "prudent man" requirement. Such rules are preempted by the Act.

88. ERISA § 404(a)(1)(B).

89. See Braverman, *Fiduciary Liability Under the Pension Reform Law of 1974*, P-H PENSION AND PROFIT SHARING ¶ 513 (1975); Cerino, *Fiduciary Responsibility: Clarifying ERISA's Impact*, PENSION WORLD, Sept., 1975, at 63, 64.

90. 26 Mass. (9 Pick) 446 (1830).

91. He is to observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.

Id. at 461.

92. See Smith, *Trustee's Duties Regarding Investments*, 4 REAL PROPERTY, PROBATE AND TRUST J. 604, 605-17 (1969); *In re Talbot's Estate*, 141 Cal. App. 2d 209, 296 P.2d 848 (1956); *In re Flynn's Estate*, 205 Okla. 311, 237 P.2d 903 (1951); *King v. Talbot*, 40 N.Y. 76 (1869).

inished in value, the trustee was subject to surcharge for any such loss.⁹³

The new prudent man requirement has engendered a conservative reaction to investment of equity portfolios because of the fiduciary liability which results from imprudent investment of plan assets. More importantly, the statutory rule forces the fiduciary to conform to the common law requirements that he act prudently in the selection of an investment adviser and that he regularly review the acts of his investment adviser or co-trustee.⁹⁴ Equally, the fiduciary must now establish more careful systems of recordkeeping and investment analysis; and conform to well-defined investment objectives that clearly relate to the character of the individual retirement plan.⁹⁵ Exculpatory provisions are expressly voided by the Act as contrary to public policy,⁹⁶ creating a consistent atmosphere of unmitigated fiduciary responsibility.

The "Prudent Fiduciary"

Fiduciary responsibility has made the protection of employee's interests in their retirement plans a reality. To accomplish its goal in protecting those interests Congress employed three mechanisms. First, a series of minimum standards, which included participation, vesting, funding, and disclosure were established. Secondly, to insure that these minimum standards had substance, Congress established enforcement provisions which provide substantive rules to facilitate civil and criminal action by both the government and plan participants and their beneficiaries. Finally, and most significantly, Congress created rules of conduct to set limitations on the dealers or persons who controlled or had discretion over plan administration and plan assets and, to a lesser extent, on transactions between plans and certain parties having relationships with those plans. These rules of conduct are significant in every phase of administra-

93. See Rowley and Toepfer, *Surcharging the Fiduciary*, 12 OHIO ST. L.J. 540 (1951).

94. See Smith, *Trustee's Duties Regarding Investments*, 4 REAL PROPERTY, PROBATE AND TRUST J. 604, 617-20 (1969); Henry, *Responsibility of Trustee Where Investment Power is Shared or Exercised by Others*, 9 REAL PROPERTY, PROBATE AND TRUST J. 517, 517-29 (1974).

95. See Weiss and Voboril, *Fiduciary Standards and Investment Responsibility Under the New Pension Reform Law*, 113 TRUSTS & ESTATES 800 (1974); Myers, *Successful Investment Is Prudent*, 114 TRUSTS & ESTATES 310 (1975); Kampner, *When Is a Prudent Man Prudent?*, PENSION WORLD, March, 1976, at 31; Klevan, *Fiduciary Responsibility Under ERISA's Prudent Man Rule: What are the Guideposts*, 44 J. TAX 150 (1976).

96. For the common law background of exculpatory clauses, see RESTATEMENT (SECOND) OF TRUSTS § 222(1) (1957); BOGERT, TRUSTS AND TRUSTEES § 542 (2d ed. 1960); SCOTT, TRUSTS § 222 (3d ed. 1967); see also Henry, *Responsibility of Trustee Where Investment Power is Shared or Exercised by Others*, 9 REAL PROPERTY, PROBATE AND TRUST J. 517, 529-31 (1974).

tion of the plan, and reflect the broad definition given to the term "fiduciary," a term whose application prior to the act was normally restricted to the trustee. Unlike the provisions for minimum standards, the fiduciary responsibility provisions deal with human performance, and are rules that are not quantifiable or prescribed by plan provision. The measure of the fiduciary standard is the rule of prudence. Each fiduciary, whether he is investing plan assets, determining benefits, actuarially valuing the fund or simply delegating responsibilities, must act prudently. It is incumbent upon the courts to value prudence "bearing in mind the special nature and purposes of employee benefit plans intended to be effectuated by the Act."⁹⁷ The common law of trusts did not respond to the needs of unprotected participants and beneficiaries of inequitable or ill-managed retirement plans. The Pension Reform Act creates such protection by broadly defining a fiduciary and placing upon him the requirements of prudence commensurate with the expertise he has willingly asserted. The courts must judge prudent actions in response to that assertion.

ECONOMIC ANALYSIS AND THE PENSION REFORM ACT

Economics and the Social Order

Periods in history, whether examined as economic, political or legal, will oftentimes be either dismissed or obfuscated by the historian who views them as retrogressive because they yield little logical encouragement to the advancement of a political, economic or legal theory that he values as more progressive.

At the first congress of the Soviet dictatorship of 1917, Leon Trotsky, Lenin's sardonic political apologist, dismissed Julius Martov, the most articulate Russian exponent of ideal democratic socialism,⁹⁸ and his followers from the gathering of the triumphant Bolsheviks, whose politics of party power were repugnant to Martov's visions of Marxist proletarian democracy. "You are bankrupt;" Trotsky cried, "Your role is played out. Go where you belong from now on - into the rubbish can of history!"⁹⁹ For us today, and for Trotsky as he recognized in retrospect,¹⁰⁰ Martov's fears evinced far-sighted intelligence, as Russia never realized the ideal social

97. H.R. REP. NO. 533, 93rd Cong., 1st Sess. 12 (1973).

98. R. V. DANIELS, RED OCTOBER 18-21 (1967). Orthodox Marxists split between the "Bolsheviks," or hardline conspiratorial Marxists led by Lenin, and "Mensheviks," or democratic Marxists responsive to Western democratic custom, led by Martov.

99. E. WILSON, TO THE FINLAND STATION 510-12 (1972).

100. See generally L. TROTSKY, THE LESSONS OF OCTOBER (1937).

regime contemplated by Marx. As Edmund Wilson rejoined, "There sometimes turn out to be valuable objects cast away in the rubbish can of history - things that have to be retrieved later on."¹⁰¹

In the history of legal thought the theory of the "prudent man" has experienced a variety of interpretations that are most closely analogous to theories of "reasonability." The prudent man standard embodied in the Pension Reform Act¹⁰² has presented the courts with a codified standard that had heretofore been variously interpreted within the common law framework of trust law. Congress recognized that traditional trust law rules and remedies were not responsive to the special nature of the private pension system.¹⁰³ It is incumbent upon those interpreting the standards of prudence created by the Act to regard this standard as encompassing the inherent purpose for the creation of government regulation of the private pension system — the guaranteeing of private pension rights.¹⁰⁴

The requirement demands that the prudent man act with the care, skill, prudence and diligence under the prevailing circumstances that a prudent man acting in a like capacity and familiar with such matters would use in conducting a similar enterprise.¹⁰⁵ It establishes for the pension fiduciary a higher standard, superior to that imposed upon an ordinary prudent man; the law demands no less from those whose conduct must reflect a superior knowledge, skill or intelligence.¹⁰⁶

This codified prudent man requirement is redolent of the prudent man standard originally formulated by Justice Putnam in 1830, and rearticulated many times in common law courts.¹⁰⁷ However, the requirements for strict prudence, particularly in investment, have been "cast away in the rubbish can of history" by modern-day economic exponents of the free capital market.¹⁰⁸ To be consistent, however, with the social reform intent of the Pension Reform Act, it is necessary for the courts to interpret the minimum standard of

101. E. WILSON, *TO THE FINLAND STATION* 511 (1972).

102. See text accompanying notes 42 through 47 *supra*.

103. See text accompanying notes 86 through 97 *supra*.

104. See ERISA §§ 2(a),(c).

105. *Id.* § 404(a)(1)(B) the pertinent text of which is set forth at note 4 *supra*.

106. See W. PROSSER, *THE LAW OF TORTS* § 32 (4th ed. 1971); SCOTT, *TRUSTS* §§ 174, 174.1 (3d ed. 1967); BOGERT, *TRUSTS AND TRUSTEES* § 541 (2d ed. 1960); Heffner, *Social Reform Aspects of Pension Reform Law Add to Liabilities of Investment Managers*, *PENSIONS & INVESTMENTS*, April 14, 1975, at 23.

107. See Shattuck, *The Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century*, 12 OHIO ST. L.J. 491 (1951).

108. See text accompanying note 136 *infra*.

prudence for fiduciaries of pension plans solely in the interests of providing benefits to participants and beneficiaries of the plan. Rather than having played out its role, the rule of prudence has assumed new dimensions as the absolute measure of fiduciary responsibility.

A study of modern capital market theory and its relevance to the rule of prudent portfolio investment of retirement fund assets acts as a paradigm of prudent fiduciary conduct as viewed within the framework created by modern economic analysis of law. Essential to an understanding of the basis upon which the theories of modern economic analysis of law have been formed is an awareness that its modern exponents have recalled the philosophy of the classical economic theorists. Adam Smith, the first among the classical social prophets of the capitalist system, had sought in his *Wealth of Nations* to formulate rules for action in the economic sphere, both to provide a general theoretical framework for study and to provide guidance for the goal of efficient economic policy. He firmly believed that the unfettered operation of the "market" system would maximize all the myriad of exchange relationships that would ultimately and logically add to the distributive consequences of wealth consistent with the society's capacity to produce. Inimical to the efficient operation of this "invisible hand" of free competition was government interference, which Smith felt would reduce the efficiency of the economic system.¹⁰⁹ Smith's successors, Thomas Malthus and David Ricardo, similarly reasoned that the best economic policy in an expanding economy is to encourage the growth of profit, the primary regulator of the rate of economic expansion.¹¹⁰ John Stuart

109. Though he disparaged the mercantilist pattern of economic control—a philosophy that necessarily implied a considerable degree of state intervention in economic activity—Smith did not completely embrace a regime of laissez-faire capitalism, because he recognized that unregulated private interests suppress the progress of an efficient economy. Thus, he strove for maximization of competition. See generally A. SMITH, *THEORY OF THE MORAL SENTIMENTS* (1759) and *AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS* (1776). For an excellent review and analysis of the central ideas expounded in these two works see W. J. BARBER, *THE HISTORY OF ECONOMIC THOUGHT* 23, 48-49 (1968) [hereinafter cited as BARBER].

110. Unlike his contemporaries, Malthus made a case for government expenditures for the public good, but was generally an advocate of the free market system and an opponent of government restrictions. See generally T. R. MALTHUS, *PRINCIPLES OF POLITICAL ECONOMY* (1820). See BARBER, *supra* note 109, at 58-64.

Ricardo believed that long-range capital growth would inevitably lead to the displacement of labor by machines, unless foreign trade was allowed to expand under his theory of "comparative costs." This theory simply encourages the inherently efficient exchange of capital goods between two nations when one nation can produce at a lower cost than the other. Necessary to such an efficient exchange is the absence of government restrictions. See generally D. RICARDO, *PRINCIPLES OF POLITICAL ECONOMY AND TAXATION* (1817). See BARBER, *supra* note 109, at 73-89.

Mill's qualitative considerations of economic policy, however, went beyond theories based solely on profits, and provided an outline of a more egalitarian program of government intervention to stabilize the economy.¹¹¹

Classical economic theory formulated, in a theoretical sense, the proposition that a free market economy can be beneficial for the public good because of the general prosperity that it engenders. The realistic offerings of Mill perceived the fallability of theories based solely upon a hypothesis of quantity measured in terms of efficiency. This awareness led the classical age of economics into the socially dynamic ideology of Karl Marx and ultimately to the revisionist departures reflected in the "general theory" of John Maynard Keynes.¹¹² Modern economic analysis of law recalls the theories of the classical economists by measuring economic performance in terms of market "efficiency."

Modern Economic Analysis of Law

The impact of law upon the social patterns and practices of society is readily apparent. Economics can be used to analyze a broad range of questions of legal interpretation and policy. Professor Richard Posner of the University of Chicago Law School analyzes these questions by examining six broad areas of modern legal thought and interpretation.¹¹³ His thesis is that economics is the science of human choice in a world that is limited in resources in relation to human wants. Man, Professor Posner maintains, is a

111. Mill's theories contained at least the outlines of a more active program of government intervention by emphasizing the state as a "civilizer"—the sponsor of basic cultural institutions, and most importantly, as a stabilizer of economic profits. By aspiring to a more socialist ideal that valued cooperative arrangements and partnerships between capital and labor, Mill looked forward to a time when the division of wealth would be made by "... concert on an acknowledged principle of justice." See generally J. S. MILL, *PRINCIPLES OF POLITICAL ECONOMY* (1844). See BARBER, *supra* note 109, at 94, 101.

112. Marx's visions of the proletariat revolution are well known. See generally K. MARX, *DAS KAPITAL* (1867).

Keynes focused on the determination of levels of national income and employment in industrial economies and the cause of economic fluctuations. To maintain economic stability and full employment, he argued, meant that government must play a more active role in fiscal policy. See generally J. M. KEYNES, *GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY* (1931).

113. R. POSNER, *ECONOMIC ANALYSIS OF LAW* (1972) [hereinafter cited as POSNER]. After an introductory chapter on economic theory the book examines: (1) The common law (property, contracts and tort law); (2) public regulation of the market (antitrust, public utilities, and labor law); (3) the regulation of business organizations and financial markets (corporations, capital markets and conglomerates); (4) law and the distribution of income and wealth (taxation, probate, and poverty law); (5) the constitution and the federal system (due process, federalism and civil rights); and (6) the legal process (the legislative process, the courts, and law enforcement).

rational maximizer of his ends in life, his satisfactions or his "self interest."¹¹⁴ Basic to an understanding of man's rationalization of this "self interest" is the acceptance of the theory that resources will gravitate toward their highest valued uses if exchange is permitted.¹¹⁵ When this is accomplished, the resources are being employed "efficiently."¹¹⁶ Efficiency, as a widely regarded value in the world, can be persuasive in shaping public choice between two alternative actions, one of which seems more efficient.¹¹⁷ Logically then, legal rules and restrictions should be designed to facilitate economic efficiency and should make use of the competitive market to assign rights to the party whose use is the more valuable.¹¹⁸

The central questions that an economic analyst asks before any rational choice between two opposing parties is made, are: (1) how much will it cost; (2) who pays; and (3) who ought to decide both questions.¹¹⁹ In the unencumbered market, when it is free of "transaction costs," the most efficient and value-maximizing decision is made, because the parties will determine between themselves whose legal right is more valuable.¹²⁰ The value of that right is determined by the willingness to pay for it. Hence we have come full circle. Efficiency has been fulfilled because self-interest has been maximized.¹²¹

Professor Posner generally reacts unfavorably to government regulation of the market. Efficiency is maximized when the market is allowed to run its free course, because a free market will regulate itself through efficient exchange. The role this unencumbered ex-

114. POSNER, *supra* note 113, at 1.

115. *Id.* at 4.

116. "Efficiency" is a technical term meaning the exploitation of economic resources in such a way that human satisfaction, as measured by consumer willingness to pay, is maximized. *Id.*

117. *Id.* at 6.

118. *Id.* at 18.

119. Leff, *Economic Analysis of Law: Some Realism About Nominalism*, 60 VA. L. REV. 451, 460 (1974) [hereinafter cited as Leff].

120. POSNER, *supra* note 113, at 17. See Coase, *The Problem of Social Cost*, 3 J. LAW & ECON. 1 (1960). "Transaction costs" are the costs of coming to mutually advantageous agreements. The "Coase Theorem" states that if transaction costs are zero, then efficiency will be achieved regardless of which party is assigned the property right in a situation of conflicting uses.

121. In other words, since people are rationally self interested, what they do shows what they value, and their willingness to pay for what they value is proof of their rational self interest. Nothing merely empirical could get in the way of such a structure because it is definitional. That is why the assumptions can predict how people behave: in these terms there is no other way they can behave.

Leff, *supra* note 119, at 457. Thus, Posner's definitional basis is self fulfilling and undisputable because it is based upon human nature.

change can play in the deciding of legal issues, then, becomes self-evident. By mimicing the free market, legal rules would create rights in those individuals whose use of those rights would be more valuable in terms of efficiency. Law that is based upon good economics, however, will most likely be attuned to the market's function of maintaining social order, which is not necessarily parallel to insuring efficiency or maximizing value.¹²² Essentially, Professor Posner's adherence to a belief in free market exchange as the instrument of social good, because it maximizes value, is a reversion to the free market theories of Smith, Malthus and Ricardo,¹²³ where maximum profitability and capital accumulation, analogously "efficient" principles, theoretically provided for the public welfare. Rather than encourage the consideration of the stresses of certain elements of economic legislation upon the social order so that a legislator might make a rational choice, Professor Posner places an overriding value on economic efficiency per se.¹²⁴ Maximum value, however, is not necessarily in itself the ultimate objective; economic efficiency may be used as an instrument to obtain further objectives.¹²⁵ It serves as a conceptual device by which to assess the value of the prudent man standard in fiduciary responsibility.

The "Prudent Man Rule" and Modern Capital Market Theory

The "prudent man rule" has most often been the measure of care required by an investment adviser. The rule is no longer restricted to such usage under the Pension Reform Act, but extends to all fiduciary duties encompassed by the Act.

Two theoretical questions must be considered before the goals of

122. See Buchanan, *Good Economics - Bad Law*, 60 VA. L. REV. 483, 486 (1974) [hereinafter cited as Buchanan].

123. What Posner has done is "recruited two divergent strands of rational intellectual tradition, the classical economic rationalism sired by Adam Smith and the common law rationalism which can be said to date from William Blackstone." Carrington, Book Review, 1974 U. ILL. L.F. 187.

See also POSNER, *supra* note 113, at 156:

Monopoly, pollution, fraud, mistake, mismanagement, and other such by-products of the market process are conventionally viewed as failures of the self-regulatory mechanisms of the market and, therefore, as appropriate occasions for public regulation. This way of looking at the matter is misleading. The failure is ordinarily a failure of the market and of the rules of the market prescribed by the common law.

124. See Buchanan, *supra* note 122, at 485-86. For an example of economic analysis examining the effect on the social order, see Breit and Elizinga, *Antitrust Enforcement and Economic Efficiency: The Uneasy Case for Triple Damages*, 17 J. LAW & ECON. 329 (1974).

Public policy to promote competition is explained as an attempt to come to grips with "market failure." Market failure occurs when voluntary exchanges do not sustain desirable activities or eliminate undesirable ones.

125. Buchanan, *supra* note 122 at 485.

fiduciary responsibility can be effectively implemented:¹²⁶ first, whether it is proper to codify standards of fiduciary responsibility at all; and if so, second, whether it is proper in framing these standards to exclude considerations other than economic efficiency.

As previously emphasized, abuses and inequalities endemic in private pension plans led Congress to enact minimum standards and requirements under the Pension Reform Act.¹²⁷ The fiduciary responsibility requirements measure the performance of fiduciaries who carry out the requirements of the law, and are the essence of congressional intent to regulate private pension plans.

Because Congress found it necessary to codify standards of fiduciary responsibility, it is proper to proceed to the second theoretical question: whether it is proper, in fashioning these standards, to exclude considerations other than economic efficiency, such as the merit of favoring the equitable rights of pensioners or of altering the distribution of pension benefits. The answer to this question requires a familiarity with capital markets and the theory of investments, because such background suggests the proper response.

Investors of common stock purchase shares of such stock at prices that simply reflect the share's expected earnings discounted to present value. Between two stocks that have identical expected earnings, an investor will pay a higher price for the lower risk stock. High risk stocks have a greater expected return.¹²⁸ Risk is determined by the volatility of the stock as compared to the market as a whole. The higher the return an investor desires, the more willing he must be to accept risk.¹²⁹ A well-diversified investment portfolio will be far less risky than a portfolio that holds only a few securities. The modern theory of portfolio management proposed by Professor Harry Markowitz analyzed the implications of the fact that investors, though seeking high expected returns, generally wish to avoid risk.¹³⁰ Under the theory he developed, Markowitz pointed out that: (1) the two relevant characteristics of a portfolio are its expected return and its riskiness; (2) rational investors will choose to hold efficient portfolios to maximize or minimize risk; and (3) that it is

126. This methodology is suggested by Posner himself. See Posner, *A Program for the Antitrust Division*, 38 U. CHI. L. REV. 500, 501 (1971).

127. See text accompanying notes 15 through 97 *supra*.

128. POSNER, *supra* note 113, at 191.

129. *Id.* at 192. Risk is measured in terms of probability of volatility and is plotted on distribution curves that show the expected return of the security. Thus, risk is an important concept in security analysis. J. FRANCIS, *INVESTMENTS: ANALYSIS AND MANAGEMENT* 241, 252 (1972).

130. See M. HAMILTON & J. LORIE, *THE STOCK MARKET: THEORIES AND EVIDENCE* 171 (1973).

theoretically possible to identify efficient portfolios by the proper analysis of information for each security on its expected return, the variance in that return, and the relationships between the return for each security and that for every other security.¹³¹

Professor Posner characterizes the stock market as an efficient market, in which new information is disseminated so rapidly that there is no opportunity for fraud. Thus, he alleges that the costs of research and execution and the resultant under-diversification entailed by efforts to exceed the returns of the market generally do not exceed those returns and are inefficient.¹³² Posner extends this thinking by illustrating his point that efficiency is reduced by applying the prudent man rule to trusts,¹³³ which, he maintains, requires the review and analysis of each security regarding its purchase, retention or sale. Such individual determination of each security necessarily restricts the number of issues available to the portfolio due to the excessive costs incurred in maintaining a large research pool of analytical information. Finally, he is critical of the application of the prudent man standard to the performance of individual investments rather than the overall performance of the portfolio.¹³⁴ "With the law so out of phase with economic reality," Posner expects that extensive exculpatory provisions would relieve the investor by removing a transaction cost that is an obstacle to market efficiency.¹³⁵

Three recent articles have argued that the efficiency inherent in the free capital market allows investors to increase their returns through risk manipulation and to proscribe the use of such fluid management, devoid of any standard except minimum prudence, would unnecessarily restrict the efficient growth potential of the fund.¹³⁶ Each echoes the Posner thesis that to promote efficiency, the courts must shift the emphasis away from individual securities and instead measure the risk of entire portfolios as representative of total return.

To counter this theory it is necessary to attack the efficacy of

131. *Id.* at 172.

132. POSNER, *supra* note 113 at 193. See Black, *Implications of the Random Walk Hypothesis for Portfolio Management*, FIN. ANALYSTS J., March, 1970, at 1.

133. POSNER, *supra* note 113, at 196.

134. *Id.* at 197.

135. *Id.*

136. See Note, *Trustee Investment Powers: Imprudent Application of the Prudent Man Rule*, 50 NOTRE DAME LAW. 519, 525, 528 (1975); *Fiduciary Standards and Pension Plans*, *supra* note 71, at 969-79; Note, *The Regulation of Risky Investments*, 83 HARV. L. REV. 603, 625 (1970). See also Williams, *The Prudent Man Rule of the Pension Reform Act of 1974*, 31 BUS. LAW. 99 (1975) [hereinafter cited as Williams].

"efficiency" as the standard upon which a court of equity must base its decision in an action brought by a plan participant. Efficiency is an indefinable goal, self-serving and continuous. For optimum efficiency there cannot be transaction costs, hence its weakness as a theory in determining legal rights is evident. By assuming that efficiency is the goal of the law, Professor Posner ignores the interrelationship of the "market" and the political process. The issue is not, for each consumer/citizen, what he gains from the market or from politics, but what he derives from the society which is a product of both these systems.¹³⁷ To illustrate, it can be seen that the "single vocabulary" approach used by Professor Posner approximates the "presentation" theory of Professor Ian Macneil. Macneil argues¹³⁸ that contracts consist of much more than pure independent promises, but include a variety of components coequal with the intended promise. By freeing contract theory from the myth of pure transactionism, Macneil forces the contracting parties to view their contract on the basis of transactional-relational analysis which realistically reflects the fact that exchange in our complex society defies limitation to merely a single component—the promise.¹³⁹ Similarly, market transactions involving investments cannot ignore the social goals attending each investment.

Law is a stabilizing institution providing the necessary boundaries within which individuals can plan their own affairs predictably and with minimal external interferences.¹⁴⁰ Thus, the law facilitates contract relationships by binding the parties to their agreement, and can provide the allocation of rights to encourage free market transactions and reduce costs. But legislation that represents the securing and implementing of explicit or collective social objectives, rather than encouraging individual free market transactions, becomes the dominant value of a society. The citizen is not concerned with the efficiency of the market but rather with the benefits he derives from society.

137. Leff, *supra* note 119, at 467.

138. See Macneil, *Restatement (Second) of Contracts and Presentation*, 60 VA. L. REV. 589 (1974).

139. "Relativity" may be a suitable analogy here. Isaac Newton assumed that "[a]bsolute, true, and mathematical time, of itself and from its own nature, flows equally without relation to anything external. . . ." This assumption, as Albert Einstein saw, was magnificent but untenable, and was a paradox of modern physics. The speed of light may be constant, but is relative to the observer's frame of reference. The closer the observer himself gets to the speed of light, the closer he comes to stopping time itself. See Newman, *Einstein's Great Idea*, in *ADVENTURES OF THE MIND* 235, 243 (1960).

Thus presentation and efficiency are relative to external variances, be they social or legal in nature.

140. Buchanan, *supra* note 122, at 489.

Finally, the study of efficient markets settles on the application of policy-analytic and microeconomic techniques. The major difficulty with this approach is that it looks to the pattern of end results of the transactions without reference to the process that generated them. "Being assigned a right on efficiency grounds fails to satisfy the particular needs that can be met only by a shared social and legal understanding that the right belongs to the individual."¹⁴¹ Policy-analytic methods, such as economic analysis, overlook complex structures of socially articulated standards upon which a right is based. When Congress passed the Pension Reform Act, it required fiduciary standards to be measured not in terms of efficiency relative to the market, but by the socially determined standard of prudence that protects the rights of plan participants.

In *Spitzer v. New York*,¹⁴² the New York Court of Appeals specifically addressed the issue of the investment responsibilities of fiduciaries. This action involved a suit by the guardian *ad litem* of a participating trust in connection with the common trust fund of the Bank of New York.¹⁴³ The guardian argued that the overall investment performance of the fund did not shield the trustee from losses sustained as a result of negligence with respect to particular investments.¹⁴⁴ Though the court of appeals carefully weighed the merits

141. See Tribe, *Technology Assessment and the Fourth Discontinuity: The Limits of Instrumental Rationality*, 46 S. CAL. L. REV. 617, 629-30 (1973). Technology has been blamed for dehumanizing the population because it has escaped from human control. For a sampling of this thought see L. MUMFORD, *THE MYTH AND THE MACHINE* (1967) and *THE PENTAGON OF POWER* (1970); C. A. REICH, *THE GREENING OF AMERICA* (1970); R. DUBOS, *SO HUMAN AN ANIMAL* (1968).

Technological assessment attempts to show how society can assess and determine the scope and solutions for technological problems.

142. 35 N.Y.2d 512, 323 N.E.2d 700 (1974). See Williams, *supra* note 136, at 101-5.

143. The action was brought under section 100-c of the New York Banking Law which mandates that every four years common trust funds must hold an accounting. The Surrogate denied the motion for summary judgment as to two of the four investments. *Matter of Bank of New York*, 43 A.D. 2d 105 (App. Div. 1st Dept. 1973). The Appellate Division dismissed the remaining two objections. Brief for Appellant at 2, *Spitzer v. New York*, 35 N.Y.2d 512, 323 N.E.2d 700 (1974).

Common trust funds are special funds maintained by banks exclusively for the collective investment and reinvestment of moneys contributed by the bank as trustee or executor. Each participating trust receives units valued by the underlying value of the common trust. See Atnally, *The Investment Responsibilities of Fiduciaries*, 114 TRUSTS & ESTATES 286 (1975).

144. The guardian argued that such a principle was based upon the common law of trusts. In SCOTT, TRUSTS § 213.1 (3rd ed. 1967) the rule is reiterated:

A trustee who is liable for a loss occasioned by a breach of Trust in respect of one portion of the Trust property cannot reduce the amount of a gain which has accrued with respect to another portion of the Trust property through another distinct breach of trust.

Brief for Appellant at 42, *Spitzer v. New York*, 35 N.Y.2d 512, 323 N.E.2d 700 (1974). See also RESTATEMENT (SECOND) OF TRUSTS § 213 (1957).

of each investment¹⁴⁵ and did not find the actions of the trustees imprudent, it nevertheless held that:

The fact that this portfolio showed substantial overall increase in total value during the accounting period does not insulate the trustee for responsibility for imprudence with respect to individual investments for which it would otherwise be surcharged. To hold to the contrary would in effect be to assure fiduciary immunity in an advancing market. . . . The focus of inquiry. . . is nonetheless on the individual security as such and factors relating to the entire portfolio are to be weighed only along with others in reviewing the prudence of the particular investment decisions.¹⁴⁶

The court did not look to the efficiency of the investment procedures involved, nor was it in any way concerned with the inefficiencies of actively analyzing individual securities. On the contrary, the court noted that the matter of negligent investment will turn on

a balanced and perceptive analysis of its consideration and action in the light of the history of each individual investment, viewed at the time of its action or its omissions to act.¹⁴⁷

The court was concerned with the protection of the trust beneficiaries, and not with the inefficiencies sustained by the free market when such exchanges must endure transaction costs in the way of careful and thorough review of investment decisions.

Therefore, the response to the second theoretical question posed by an economic analysis of law is negative. When fashioning fiduciary responsibility standards, the court cannot exclude considerations other than economic efficiency, but must favor the equitable rights of plan participants whose interests are paramount in the application of broad, social legislation.

CONCLUSION

The rule of prudence as the measure of fiduciary responsibility can properly be seen as the legislative response to public demands for the "rectification of palpable and remediable inefficiencies and inequities in the operation of the free market."¹⁴⁸ Though many examples can be shown that particular schemes of government regulation alter market operations which are not explicable on public

145. 35 N.Y.2d 512, 516-17, 323 N.E.2d 700, 703-04.

146. 35 N.Y.2d 512, 517, 323 N.E.2d 700, 703 (citations omitted).

147. *Id.* at 704.

148. Posner, *Theories of Economic Regulation*, 5 BELL J. ECONOMICS AND MANAGEMENT SCIENCE 335, 336 (1974) [hereinafter cited as *Economic Regulation*].

interest grounds,¹⁴⁹ the Pension Reform Act must be viewed as public interest regulation which is responsive to widely accepted standards of equity, fairness and justice. Congress has established minimum standards for participation, vesting and accrual of benefits in order to more equitably distribute retirement benefits, and has provided the means for enforcement of these provisions through civil actions. Fiduciary standards have been created to facilitate the protection of plan participants and to guarantee that retirement benefits are not an elusive dream. The rule of prudence measures the fiduciary's responsibility, and requires that the interests of the plan participants remain foremost in importance when he makes discretionary decisions.

Economic analysis would find inefficiency merely in the fact that regulatory bodies have been created to enforce the Act provisions.¹⁵⁰ However, efficiency per se cannot be the measure of prudence.¹⁵¹ The rights of the participant have not been delegated because of his willingness to accept risk in the investment of his retirement assets. His right to a retirement income is assigned by the government acting to facilitate the equitable distribution of benefits and effectuate the goals of the public interest. Equity and justice, rather than market efficiency, protect the public welfare.

TIMOTHY R. GARMAGER

149. *Id.* at 337. See Schuck, *Why Regulation Fails*, HARPER'S, Sept., 1975, at 16. Generally, the indictment of federal regulatory agencies centers on the argument that they create inflation of costs to consumers, encourage inefficiency in critical sectors of the economy, stifle innovation, corrupt the political and administrative processes by the regulated interests, and enervate the competitive force in the economy.

150. See *Economic Regulation*, *supra* note 148, at 338-39.

151. Professor Posner, in conjunction with Professor John H. Langbein, have recently reasserted the view that the process of individual stock selection is inefficient relative to the return on those investments in the total portfolio. See Langbein and Posner, *Market Funds and Trust-Investment Law*, 1976 A.B.F. RES. J. 1. Recognizing that the courts may reject the capital markets approach in fulfilling the fiduciary responsibilities of fund managers, Professors Posner and Langbein advocate the use of "index funds" as the most efficient way to participate in the equity market, and still meet the common law requirements of diversification and preservation of capital. An "index fund" requires the construction of a portfolio that resembles the stock market as a whole (e.g., by matching the Standard & Poor's 500 average). The market-linked performance of the fund removes much of the management responsibility of the fund manager, and reduces the pension fund manager's concern about prudence because his discretion is appreciably reduced.

The index fund theory, however, arises from the same body of knowledge which created the efficient market theory, and is aimed more at facilitating the needs of the corporate plan sponsor than the plan beneficiaries. It concedes that a search for excellence in investment management is futile, and sacrifices the beneficiaries' interest in an appreciable gain in the fund. The public interest is not served by the presence of mediocre fund performance that results from an apparent circumvention of fiduciary responsibility under ERISA.