AUTOENROLLMENT AND ANNUITIZATION: ENABLING 401(K) "DB-ATION"

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Over the last 25 years, the retirement landscape has witnessed a dramatic shift from defined benefit ("DB") plans toward defined contribution ("DC") plans, especially 401(k) plans. Unfortunately, many employees in 401(k) plans are at a disadvantage compared to their DB plan predecessors with regard to accumulating sufficient retirement savings. This Note discusses two features that employers should incorporate as part of their 401(k) plans in order to increase plan participation and to protect employees' long-term interests: automatic enrollment and employer-sponsored annuitization option.

INTRODUCTION

The Employee Retirement Income Security Act of 1974 ("ERISA") labeled a two-pronged approach to retirement plans by way of the defined benefit ("DB") plan and the defined contribution ("DC") plan.[1]

On the one hand, DB plans generally pay a fixed monthly benefit at the time of an employee's retirement, typically based on a formula that incorporates the employee's years of service and compensation with his or her employer. For example, a common DB plan formula would provide a benefit of 1.5% times final average earnings times years of service.[2] In a DB

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1. *See* Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 1001-1369 (2006)); ERISA § 3(35), 29 U.S.C. § 1002(35) (2006) (providing definition of a DB plan); ERISA § 3(34), 29 U.S.C. § 1002(34) (2006) (providing definition of a DC plan).

2. From such a formula, an employee could work for an employer from age 25 to age 65 and accrue an annual retirement benefit of 60% of his or her salary at retirement (1.5% x 40 Years of Service = 60%). The rationale behind this set-up partly derives from the traditional belief of retirement specialists that a retirement "replacement ratio" of 60-70% is sufficient for employees to maintain their standard of living through retirement. *See* EMILY S. ANDREWS, THE CHANGING PROFILE OF PENSIONS IN AMERICA 129-30 (1985). Thus, by working from age 25 through age 65 at an employer with a 1.5% DB formula, an employee could theoretically earn a benefit that would maintain his or her standard of living into retirement, ignoring the impact of the individual's Social Security benefits and private savings.

plan, the employer generally assumes investment risk by investing plan assets in a trust and promising to pay employees' monthly benefits at the time they retire; thus, if the employer's investment returns are inadequate, the employer is responsible for contributing additional amounts to fund the plan.[3] In a DB plan, the employer also assumes longevity risk by promising to pay an employee's benefits throughout his or her expected lifetime; thus, if an employee outlives his or her expected lifespan, it is the employer who must contribute additional amounts to fund the additional benefits.[4]

On the other hand, DC plans provide for fixed contributions to the plan as opposed to fixed benefits at retirement.[5] Contributions are usually determined as a percentage of annual salary and can be made by the employer or by the employee. Today, the most common type of DC plan is the 401(k) plan; accordingly, the 401(k) plan will be the focus of the discussion below regarding DC plans.[6] In a 401(k) plan, an employee is offered a variety of funds (for example, a stable value fund or a large-cap U.S. equity fund, among others) into which he or she can invest plan contributions.[7] In the 401(k) context, employers generally provide matching contributions

3. *See* Edward Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 458 (2004) ("[DB] arrangements impose investment risk upon the sponsoring employer because the employer, having promised specified retirement benefits, must provide the additional contributions to fund those promised benefits even if the plan's assets earn disappointing returns.").

4. *See id.* at 462 ("[A DB] plan provides. . . protection against longevity risk because [it] . . . continues such annuity-type payments until the participant's death. . . . With such a lifetime annuity it is by definition impossible for the retiree to outlive her pension income. . . ").

5. *See* ERISA § 3(34), 29 U.S.C. § 1002(34) (2006). Under a simple DC plan formula, for example, a plan could provide that the employer will contribute 6% of the employee's compensation each year into an individual account for that employee which will grow with interest until the employee reaches retirement age.

6. *See* I.R.C. § 401(k) (2006): EMPLOYEE BENEFITS SEC. ADMIN., DEP'T OF LABOR, PRIVATE PENSION PLAN BULLETIN: ABSTRACT OF 2006 FORM 5500 ANNUAL REPORTS 2 tbl.A1, 42 tbl.D4 (2008), http://www.dol.gov/ebsa/PDF/2006pensionplanbulletin.pdf. [hereinafter BULLETIN] (In 2006, of 645,971 DC plans, 465,653 (72%) were 401(k) plans).

7. *See* I.R.C. § 401(a)(35)(D) (2006); HEWITT ASSOCIATES, TRENDS AND EXPERIENCES IN 401(K) PLANS 2007, at 4 (2007), http://www.hewittassociates.com/_MetaBasicCMAssetCache_/Assets/Articles/401kHI07.pdf (noting that in 2007, 84% of 401(k) plans offered stable value funds and 98% offered large-cap U.S. equity funds).

such that if employees contribute a certain amount of salary into the plan, the employer will "match" those contributions up to a certain percentage.[8] For example, an employer could contribute 50% of every dollar contributed by the employee into a 401(k) plan up to a maximum of 6% of compensation.[9]

In a 401(k) plan, the employee generally assumes the investment risk because he or she makes the investment decisions and, if they turn out to be unwise, the employee is responsible to make up for the shortfall.[10] Similarly, in a 401(k) plan, the employee assumes longevity risk because the plan typically pays benefits in the form of a single-sum distribution at retirement, rather than as a lifetime annuity.[11]

I.
THE PROMINENCE OF 401(K) PLANS

A. *Introduction of 401(k) Plans*

From the 1930s through the mid-1970s, the DB plan was the most common type of retirement plan.[12] However, there has been a steady decline in DB plans since the early 1980s in

8. *See* I.R.C. § 401(m)(4)(A) (2006) (definition of matching contributions); Keenan Dworak-Fisher, *Employer Generosity in Employer-Matched 401(k) Plans, 2002-03*, MONTHLY LAB. REV. 11, 18 n.5 (Sept. 2007) (citing studies that suggest that at least 80% of 401(k) plans offer matching contributions).

9. This corresponds to the median employer matching contribution rate of 3% as observed in Sarah Holden & Jack Vanderhei, *Contribution Behavior of 401(k) Plan Participants*, 238 EBRI ISSUE BRIEF 13 tbl.6 (2001).

10. *See* Zelinsky, *supra* note 3, at 458 ("[DC] arrangements shift the risk of poor (and the rewards of better) investment performance to the employee, because her entitlement under the plan is her account balance, however low (or high) that balance might be."); ALICIA H. MUNNELL & ANNIKA SUNDÉN, COMING UP SHORT: THE CHALLENGE OF 401(K) PLANS 9 (2004) ("[E]mployees both enjoy the gains and suffer the losses of their investment decisions [in 401(k) plans]."); BULLETIN, *supra* note 6, at 44 tbl.D6 (in 2006, of 465,653 401(k) plans, 394,729 (85%) permitted participants to direct all investments).

11. *See* MUNNELL & SUNDÉN, *supra* note 10, at 143 ("401(k) plans generally pay out benefits as lump sums. Lump-sum payments mean that retirees have to decide how much to withdraw each year. They face the risk of either spending too quickly and outliving their resources or spending too conservatively and consuming too little"); HEWITT ASSOCIATES, *supra* note 7, at 4 (noting that in 2007, all 401(k) plans surveyed offer lump sum payments while only 15% offer an annuity form of payment).

12. *See* Samuel Estreicher & Laurence Gold, *The Shift from Defined Benefit Plans to Defined Contribution Plans*, 11 LEWIS & CLARK L. REV. 331, 331 (2007).

favor of 401(k) plans.[13] 401(k) plans were first introduced via the U.S. tax code in 1978,[14] and were originally derived from employer attempts to provide employees with a deposit in a tax-deferred plan as an alternative to a bonus.[15] Section 401(k) was a Congressional compromise—employers could make those deposits, but such deposits would only avoid taxation if excessive benefits were not given to highly-compensated employees.[16]

At the time 401(k) was introduced, the belief in Congress was that these so-called "cash or deferred arrangements" would be mere supplements to employers' primary plan offerings then in existence, whether DB or DC.[17] However, 401(k) plans became extremely popular among employees and em-

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13. *Compare Funding Challenge: Keeping Defined Benefit Pension Plans Afloat: Hearing Before the Senate Finance Comm.*, 108th Cong. 2 (2003) (statement of Henry Eickelberg, Staff Vice President for Benefits Programs for the Gen. Dynamics Corp., representative of the Am. Benefits Council) ("The total number of [DB] plans [was] 170,000 in 1985") *with* BULLETIN, *supra* note 6, at 2 tbl.A1 (in 2006, there were only 48,579 DB plans); *see also* BULLETIN, *supra* note 6, at 2 tbl.A1 (As of 2006, 645,971 of a total of 694,550 employer-sponsored plans (93%) were DC plans), ALICIA H. MUNNELL & ANNIKA SUNDÉN, CTR. FOR RETIREMENT RES. AT B.C., 401(K) PLANS ARE STILL COMING UP SHORT 2 fig.3 (2006), http://crr.bc.edu/images/stories/Briefs/ib_43.pdf (As of 2004, of retirement plan participants, 63% were in DC plans only, 20% were in DB plans only and 17% were in DC and DB), *and* HEWITT ASSOCIATES, *supra* note 7, at 2 (in 2007, 65% of employers surveyed report that the 401(k) plan was their primary program for retirement as compared to 35% 10 years earlier).

14. *See* Revenue Act of 1978, Pub. L. No. 95-600, §135, 92 Stat. 2763, 2785-87 (codified as amended at I.R.C. § 401(k) (2006)).

15. *See, e.g.*, Norman P. Stein, *An Alphabet Soup Agenda For Reform of the Internal Revenue Code and ERISA Provisions Applicable to Qualified Deferred Compensation Plans*, 56 SMU L. REV. 627, 659 (2003) ("401(k) plans, as we know them today, might be thought of as an unintended consequence of legislation designed to address a narrow issue.").

16. *See, e.g.*, MUNNELL & SUNDÉN, *supra* note 10, at 5. *See also* I.R.C. §§ 401(k)(3), 402(g)(1) (West Supp. 2008) (the nondiscrimination test required for 401(k) plans and the annual limit that can be contributed into a 401(k) plan, respectively).

17. *See* I.R.C. § 401(k) (West Supp. 2008) (titled "Cash or deferred arrangements"); section 135 of the Revenue Act; S. REP. No. 95-1263, at 88-89 (1978), *reprinted in* 1978 U.S.C.C.A.N. 6761, 6851-52 (noting that the 401(k) provision allows employees whose employers already provide retirement plans such as an IRA, another tax incentive to save for retirement); JOHN H. LANGBEIN, SUSAN J. STABILE & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 50 (4th ed. 2006) ("Initially 401(k) plans were regarded as supple-

ployers very quickly due to their relative ease of administration, as compared to the complex administration that ERISA mandated for DB plans, predictable costs, and transparency, among other reasons.[18]

B. *Growth of 401(k) Plans*

By 1985, Congress was blindsided by the outgrowth of the 401(k) plan; the Treasury Department responded by suggesting that 401(k) plans be eliminated, leading Congress to deliberate about whether they should be eliminated or severely restricted.[19] In the end, Congress determined that 401(k) plans were a good way to increase retirement savings but needed some additional safeguards, so section 401(k) remained intact after the Tax Reform Act of 1986.[20] In doing so, the Report of the Committee on Ways and Means reiterated the belief that 401(k) plans "should be supplementary retirement savings arrangements [and] should not be the primary employer-maintained retirement plan."[21]

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mentary plans, that is, tax-deferred savings vehicles for employees who wished to do additional saving for retirement.").

18. *See generally* MUNNELL & SUNDÉN, *supra* note 10, at 25-28 (providing background reasons on why 401(k) plans rose to popularity, particularly as compared to DB plans); LANGBEIN, STABILE & WOLK, *supra* note 17, at 49-50. Now, 94% of employers that sponsor 401(k) plans do not sponsor any other DB or DC plan. *See* BULLETIN, *supra* note 6 at 42 tbl.D4 (in 2006, of 465,653 401(k) plans, 436,992 are the only pension plan sponsored by the employer).

19. *See* 131 CONG. REC. E4322-02 (daily ed. Oct. 2, 1985) (statement of Rep. Chandler); *see also* 131 CONG. REC. S18046-02 (daily ed. Dec. 18, 1985) (statement of Sen. Baucus).

20. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 1111-1120, 100 Stat. 2085, 2435-2464; H.R. REP. No. 99-426, at 687 (1985) ("[T]he committee concludes that it is appropriate to revise the nondiscrimination rules for [401(k) plans]. . . . [T]he committee believes that it is necessary to restrict the availability of hardship withdrawals under a qualified cash or deferred arrangement to ensure that the favorable tax treatment for retirement savings is limited to savings that are, in fact, used to provide retirement income.").

21. H.R. REP. No. 99-426, at 686-87.

C. *Employer Preference of 401(k) Plans Due to Lower and More Predictable Costs*

However, since 1986, 401(k) plans have grown tremendously in number as DB plans have decreased.[22] One reason why employers have shifted to 401(k) plans is that they make more financial sense than DB plans.[23] DB plans are very costly to administer because of various ERISA and IRS requirements which generally do not apply to 401(k) plans.[24] Furthermore, DB plans are generally more expensive for employers to sponsor because of additional auditing, accounting, actuarial, legal and investment management costs.[25]

Additionally, DC plans have more predictable costs on a year-by-year basis. Funding requirements for DB plans pursuant to ERISA and IRS regulations[26] result in unpredictable swings in required contributions based on the combination of asset returns, interest rate movements and mortality among plan participants among other factors.[27] On the other hand,

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22. *See supra* note 13, at 3.

23. Susan J. Stabile, *The Behavior of Defined Contribution Plan Participants*, 77 N.Y.U. L. Rev. 71, 76 (2002) ("Employers have grown to favor defined contribution plans because they are less costly and face less complex regulatory burdens than defined benefit plans . . .").

24. *See, e.g.*, ERISA § 4006(a)(3)(A)(1), 29 U.S.C. § 1306(a)(3)(A)(1) (2006) (annual premiums due to the Pension Benefit Guaranty Corporation are required from DB plans, but not DC plans); ERISA § 205(b)(1)(C), 29 U.S.C. § 1055(b)(1)(C), I.R.C. § 401(a)(11)(B)(iii) (2006) (allow 401(k) plans to avoid the onerous joint and survivor annuity requirements that apply to all DB plans). *See also* Munnell & Sundén, *supra* note 10, at 9 ("Technically, ERISA's provisions applied to both [DB] and [DC] plans. But the main thrust of the legislation was on the [DB] side.").

25. *See* Bulletin, *supra* note 6, at 3 tbl.A1(a), 33 tbl.C10 (Total administrative expenses for plans covering more than 100 employees in 2006 were $6.3 billion for DB plans compared to $1.9 billion for DC plans, even though DC plans covering more than 100 employees outnumber DB plans covering more than 100 employees by more than 6 to 1); Stein, *supra* note 15, at 641 ("[DB] plans are generally more costly to administer, in large part because of the need to engage the services of an actuary"); Munnell & Sundén, *supra* note 10, at 27 ("[O]ver the period 1981-96 administrative costs as a percentage of payroll nearly tripled for [DB] plans, compared to less than [doubled for DC] plans.").

26. *See* ERISA §§ 302-303, 29 U.S.C. §§ 1082-1083 (2006); I.R.C. §§ 412, 430 (2006).

27. The unpredictable nature of year-to-year costs of DB plans has, in some ways, been exacerbated by the Pension Protection Act of 2006 (PPA), Pub. L. No. 109-280, § 801, 120 Stat. 780, 992-95. Under the PPA, plans may

once salary figures are known for employees, the costs of operating a 401(k) plan each year are relatively easy for an employer to predict ex ante.[28]

Another reason why 401(k) plans are less costly for employers than DB plans is that employees often do not participate in a 401(k) plan even though they are eligible to do so.[29] Employer contributions under 401(k) plans are most commonly matching contributions, as opposed to nonelective contributions which are automatically contributed whether or not an employee contributes.[30]

"smooth" asset returns over the course of two years, whereas under prior law, asset experience of the prior four years could be taken into account for smoothing purposes. *See* I.R.C. § 430(h)(3)(B) (2006). Notably, shortly after the enactment of PPA, a few large employers cut back or froze future accruals in their DB plans. *See* Jonathan Peterson, *The Nation; Law May Hasten Decline of Pensions*, L.A. TIMES, Sept. 4, 2006, at A1 (noting that DuPont & Co., Tenneco Inc. and Blount Int'l announced that they would freeze their DB plans within one month after Congress enacted PPA); *Promises, Promises*, CFO MAG., Dec. 1, 2006, *available at* 2006 WLNR 21289553. Around the same time, the Financial Accounting Standards Board issued rules that require DB plan sponsors to include asset and liability figures when reporting results in financial statements, which will lead to greater volatility in financial reporting. *See* FINANCIAL ACCOUNTING STANDARDS BOARD, SUMMARY OF STATEMENT NO. 158, http://72.3.243.42/st/summary/stsum158.shtml; *Promises*, *supra* ("Taken together, the new rules enacted by Congress and FASB will . . . accelerate the closing of [DB] plans by financially healthy plan sponsors.") (internal quotations omitted); JOHN H. LANGBEIN, SUSAN J. STABILE & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 19 (4th ed. Supp. 2007) ("SFAS 158 will make balance sheets much more volatile."); James E. Turpin & Jane White, *Fewer 401(k) Savers Would Be Facing Inadequate Nest Eggs if Advisers Defined Their Contribution Rate*, 38 ASPPA J. 1, 2 (2008), http://www.retirement-solutions.us/TAJ-Winter08_Turpin-White.pdf ("The Pension Protection Act effectively sounds the death knell for defined benefit pension plans.") (internal quotations omitted); Emma Cecilia Eriksson, Note, *The Pension Protection Act of 2006: Is it Too Late to Save Traditional Pension Plans?*, 41 SUFFOLK U. L. REV. 133, 152 (2007) ("Instead of rescuing defined-benefit pension plans, the [PPA] eradicates them.").

28. *See* David Rajnes, *An Evolving Pension System: Trends in Defined Benefit and Defined Contribution Plans*, EBRI (2001), *available at* http://www.cucfa.org/news/pension_table.html (DC costs are more predictable than DB costs because the employee assumes investment risk); Jerry Geisel, *Defined Benefit Plans on the Ropes, but Show Signs of Small Comeback: After Years of Uncertainty, Cash Balance Design Growing in Popularity*, BUS. INS., Oct. 8, 2007, at 38 (noting that employers prefer DC plans because their costs are predictable).

29. *See* MUNNELL & SUNDÉN, *supra* note 13, at 3 tbl.2 (in 2004, 20.9% of eligible employees didn't participate in their employer's 401(k) plan).

30. *See* DWORAK-FISHER, *supra* note 8, at 18 n.5.

D. *Employee Preference for 401(k) Plans*

Many employees have come to prefer 401(k) plans to DB plans. One reason for this preference is that employees find 401(k) plans to be more transparent and intuitive—they understand how a 401(k) plan works since it grows like a bank account.[31]

Additionally, 401(k) plans offer increased portability of benefits compared to DB plans. Under a DB plan, an employee who stops working for an employer prior to retirement age typically has to wait until such retirement age (often 65)[32] before collecting the monthly benefit that he or she accrued with that employer.[33] For example, if an employee worked for an employer for eight years, having accrued a DB plan benefit of $400 per month payable as a life annuity at age 65, that employee would have to wait until he or she turned 65 before receiving that benefit. This employee could not rollover his or her accrued DB plan benefit into a subsequent employer's plan. Thus, a DB plan benefit is "frozen", in effect, at the time employment with each employer ceases.[34] Since DB plan bene-

31. *See* Krzystof M. Ostaszewski, *Macroeconomic Aspects of Private Retirement Programs*, 5 N. AM. ACTUARIAL J. 52, 52 (2001) (noting that one reason cited for the decline in DB plans is that employees lack understanding of such plans).

32. *See* BUREAU OF LABOR STATS., DEP'T OF LABOR, NATIONAL COMPENSATION SURVEY: EMPLOYEE BENEFITS IN PRIVATE INDUSTRY IN THE UNITED STATES, 2002-2003 93 tbl.74,(2005), http://www.bls.gov/ncs/ebs/sp/ebbl0020.pdf [hereinafter BLS SURVEY] (finding that age 65 was the normal retirement age in 66% of defined benefit plans in 2002).

33. *See* ERISA §3(23)-(24), 29 U.S.C. § 1002(23)-(24) (2006) (providing that under a DB plan, the accrued benefit is an annual benefit payable at normal retirement age). One exception to this is that when an employee terminates entitled to a very small accrued benefit (i.e., a value of less than $1,000), a DB plan may pay the benefit out immediately in the form of a single sum. *See* I.R.C. § 401(a)(31)(B)(i) (2006). Another exception is that a hybrid form of DB plan known as a cash balance plan generally allows employees to receive their benefits in the form of a single sum at the time of termination from employment. *See generally* Regina T. Jefferson, *Striking a Balance in the Cash Balance Plan Debate*, 49 BUFF. L. REV. 513, 532-37 (2001) (discussing the lump sum option generally provided for under cash balance plans); *Esden v. Bank of Boston*, 229 F.3d 154, 159-60 (2d Cir. 2000) (providing a background of how cash balance plans operate).

34. *See* I.R.C. § 401(a)(31)(A)-(E) (2008). In the original Congressional efforts leading up to ERISA, the intent was to make defined benefit plan accruals portable between employers. *See* PRESIDENT'S COMM. ON CORPORATE

fits are typically derived from final salary with each employer, an employee who works for several employers during the course of his or her career will accrue a much smaller benefit than an employee who works for a single employer.[35]

In contrast, a 401(k) plan participant is able to rollover any 401(k) vested account balance with an employer into a subsequent employer's 401(k) plan.[36] Thus, there is no "freeze" involved in the 401(k) setting—an employee can rollover his or her 401(k) account into a subsequent employer's 401(k) plan or an Individual Retirement Account (IRA) and it will continue to earn investment returns until retirement.[37]

Another reason why 401(k) plan benefits are more portable than DB plan benefits is that, in general, fewer years of service are needed for a participant to become fully vested in his or her benefits under a 401(k) plan. In a 401(k) plan, employee contributions are immediately vested and employer matching contributions become fully vested no later than the

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PENSION FUNDS AND OTHER RETIREMENT AND WELFARE PROGRAMS, PUB. POLICY AND PRIVATE PENSION PROGRAMS, A REPORT TO THE PRESIDENT ON PRIVATE EMPLOYEE RETIREMENT PLANS, at xii, 55-57 (1965). These efforts were revitalized during the Clinton administration, *see* Pension Portability Act, H.R. 1874, 103rd Cong. (1993), but were unsuccessful in reforming ERISA accordingly.

35. Under a typical 1.5% of pay formula, an employee who works for 30 years and whose salary increases 6% a year from $20,000 to $108,370 would receive an annual benefit of $49,000. *See* Michael Falivena, *Pension Portability: No Easy Solution*, PENSION & INVESTMENTS, Feb. 5, 1990, at 15, *reprinted in* LANGBEIN, STABILE & WOLK, *supra* note 17, at 165-67. If that same employee, however, worked for 5 different employers for 6 years each over that 30 year period (all of which provided the same benefit formula), the same employee would receive an annual benefit of only $27,000. *Id.* This is because the final pay at the first four employers is much less than the employee's actual final pay of $108,370. *Id. See also* Zelinsky, *supra* note 3, at 481 ("[A] job-hopping employee rarely accumulates the kind of earnings and work history with a single employer necessary to earn a substantial annuity under a [DB] plan. Consequently, a job-hopping employee is better off with a series of [DC] plans.").

36. *See* I.R.C. § 401(a)(31)(A)-(E) (2006).

37. *See* Craig Copeland, *Lump-Sum Distributions at Job Change*, 30 EBRI NOTES 2, 9 (Jan. 2009), http://www.ebri.org/pdf/notespdf/EBRI_Notes_Jan09_Rollovers.pdf ("Because of their portability, benefits in [DC plans] have the advantage of potentially experiencing real growth—rather than only nominal growth—through investment returns when individuals change jobs. This is in contrast to [DB] plans.").

time when the employee completes three years of service.[38] In contrast, DB plans are typically designed such that five years of service with an employer are required before a participant becomes fully vested in his or her benefits. Thus, if an employee moves between employers every four years and each employer sponsors a DB plan that has a five-year vesting provision, that employee will not be vested in *any* retirement benefits.[39] Since studies show that the average employee remains with his or her employer for an average of four years, it is not surprising that a 401(k) plan, with shorter vesting requirements and, therefore, more portable benefits are more popular than DB plans in the eyes of many employees.[40]

38. *See* ERISA § 203(a)(2)(B)(ii), 29 U.S.C. § 1053(a)(2)(B)(ii) (2006), I.R.C. § 411(a)(2)(B)(ii) (2006). Note that ERISA alternatively allows for a graded vesting schedule of up to six years, so long as benefits are 20% vested after two years, 40% vested after three years, 60% vested after four years and 80% vested after five years. *See* ERISA § 203(a)(2)(B)(iii), 29 U.S.C. § 1053(a)(2)(B)(iii) (2006), I.R.C. § 411(a)(2)(B)(iii) (2006).

39. *See* ERISA § 203(a)(2)(A)(ii), 29 U.S.C. § 1053(a)(2)(A)(ii) (2006), I.R.C. § 411(a)(2)(A)(ii) (2006); BLS SURVEY, *supra* note 32, at 102 tbl.83 (finding that 82% of DB plan sponsors provided for 5-year cliff vesting in their plans in 2002); BUREAU OF LABOR STATS., DEP'T OF LABOR, EMPLOYEE TENURE SUMMARY 1 (2006), http://www.bls.gov/news.release/tenure.nr0.htm [hereinafter EMPLOYEE TENURE SUMMARY] (finding that the median employee tenure of employees surveyed in January 2006 was 4.0 years). Note that ERISA alternatively allows for a graded vesting schedule of up to seven years, so long as benefits are 20% vested after three years, 40% vested after four years, 60% vested after five years and 80% vested after six years. *See* ERISA § 203(a)(2)(A)(iii), 29 U.S.C. § 1053(a)(2)(A)(iii) (2006), I.R.C. § 411(a)(2)(A)(iii) (2006).

40. *See* EMPLOYEE TENURE SUMMARY, *supra* note 38, at 1; Sarah Holden & Jack VanDerhei, *The Influence of Automatic Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement*, 283 EBRI ISSUE BRIEF 17 fig.12 (July 2005), http://www.ebri.org/pdf/briefspdf/EBRI_IB_07-20054.pdf [hereinafter *Influence of Automatic Enrollment*] (only 9% of 401(k) plan participants born between 1965 and 1974 will remain with one employer during their working career while more than half will have 4 or more jobs during their lifetime); Alicia H. Munnell, Kelly Haverstick, and Geoffrey Sanzenbacher, CTR. FOR RETIREMENT RES. AT B.C., *Job Tenure and the Spread of 401(k)s* 4 (2006), http://ccr.bc.edu/images/stories/Briefs/ib_55.pdf ("[T]he shift in coverage from a [DB] to a [DC] plan implies a reduction in average tenure of 1.3 to 3.1 years . . . ."); *see also* Steven L. Willborn, *The Problem With Pension Portability*, 77 NEB. L. REV. 344, 359 (1998) ("[E]nhanced portability would improve labor market efficiency by permitting workers to move more freely into higher-value jobs."). Note that one commentator believes that increased portability is beneficial to employers as

II.
DISADVANTAGES OF 401(K) PLANS AS COMPARED TO DB PLANS

A. *Lack of Annuity Form of Payment Offered in 401(k) Plans*

Although the shift from DB to DC has been beneficial to both employees and employers for several reasons, there have been some resulting disadvantages. One drawback from a policy standpoint is the standard of the single sum form of payment, which is the most common form of payment in 401(k) plans.[41] The single sum form of payment may actually be a positive development for some upper and middle-class employees, as it allows them to have a tax-free savings account to accumulate funds during their lifetime and allows them to pass along some of their retirement savings to their children or other heirs, which is more difficult (and sometimes impossible) to do in a DB setting.[42] The single sum form of payment is also beneficial to retirees who budget their savings well or who are very skilled investors.[43]

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well as employees. *See* Steven Sass, *Crisis in Pensions*, REGIONAL REV. 13, 14-16 (Fed. Res. Bank of Boston Spring 1993), *reprinted in* LANGBEIN, STABILE & WOLK, *supra* note 17, at 59-60 ("[Large] firms are shifting their focus from [DB plans] to [DC plans]. . . . [The DC] setup suits the emerging model of corporate employment—one of abbreviated careers and tenures.").

41. *See* JOHN SABLEHAUS, MICHAEL BOGDAN & SARAH HOLDEN, *Defined Contribution Plans Choices at Retirement: A Survey of Employees Retiring Between 2002 and 2007*, Dec. 5, 2008, at 7, *available at* http://ici.org/home/rpt_08_dcdd.pdf (finding that 52% of DC plan participants received their entire account balance as a lump sum at retirement).

42. *See* EDWARD A. ZELINSKY, THE ORIGINS OF THE OWNERSHIP SOCIETY: HOW THE DEFINED CONTRIBUTION PARADIGM CHANGED AMERICA 125 (2007) ([The] "movement from annuities to lump sums has increased the utility of individual account devices for testamentary purposes since lump sums carry the possibility of balances transmittable at the participant's death, unlike annuities which terminate upon the participant's demise." (citation omitted)). *Cf.* John H. Langbein, *The Twentieth-Century Revolution in Family Wealth* Transmission, 86 MICH. L. REV. 722, 744 (ERISA "tries to ensure that pension wealth will be consumed over the lives of the worker and his spouse." (citation omitted)).

43. This is because if a skilled investor is able to earn a higher rate of return on the single sum than the interest rate at which the benefit is annuitized, the individual will be in a better financial position than if he or she received an annuity. Additionally, a retiree who budgets his or her single sum well may be able to prolong more of his or her retirement assets than a retiree who receives an equivalent annuity.

Despite these benefits, it may be an unwise policy to pay *all* plan participants in the form of a single sum. Although there is now a cottage industry of online retirement calculators[44] and financial advisors to help individuals determine how best to budget their 401(k) withdrawals to last them throughout their expected lifetime, the obvious problem is that these calculators and advisors make determinations based on average life expectancy;[45] if those expectations do not hold (i.e., a retiree and/or his or her beneficiary live longer than expected), then there is a danger of retirement savings running dry.[46] There is another danger of improper budgeting on the part of retirees if they are given a single sum. Third-party annuity providers can annuitize single-sum retirement benefits on the open market, but individuals who purchase those products have to pay an additional premium in exchange for this service.[47] This is in contrast to a DB plan, which is required under ERISA to offer participants an annuity as the default form of payment.[48]

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44. *See, e.g.*, Bloomberg.com Retirement Planner, http://www.bloomberg.com/invest/calculators/retire.html (last visited Jan. 18, 2009); AARP Bulletin Online Retirement Calculator, http://sites.stockpoint.com/aarp_rc/wm/Retirement/Retirement.asp (last visited Jan. 7, 2009); T. Rowe Price Retirement Income Calculator, http://www3.troweprice.com/ric/RIC (last visited Jan. 7, 2009).

45. One such rule of thumb is that an employee who retires at age 65 should have an account balance of ten times their final salary. *See* Turpin & White, *supra* note 27, at 1.

46. One survey noted that 55% of seniors are unsure how much money they will need to last them throughout retirement and 61% said that they do not worry or think about having enough money in retirement. *See* Rebecca Moore, *Most Off Base With Retirement Planning and Spending*, PLANSPONSOR, Feb. 11, 2008, http://www.plansponsor.com/pi_type10/?RECORD_ID=40360.

47. *See* ZELINSKY, *supra* note 42, at 16 ("[C]ommercial insurers charge a premium for the individual annuity policies they sell because the purchasers of such policies tend to be more long-lived than their peers who do not purchase such annuities"); Colleen E. Medill, *Challenging the Four 'Truths' of Personal Social Security Accounts: Evidence From the World of 401(k) Plans*, 81 N.C. L. REV. 901, 958 (2003) ("To account for adverse selection and other transaction costs, the price charged for an annuity purchased by an individual 401(k) plan participant on the private market exceeds its expected economic value in projected lifetime payments.").

48. *See* ERISA § 205(a)(1), 29 U.S.C. § 1055(a)(1) (2006); I.R.C. § 401(a)(11)(A)(i) (2006).

Allowing pre-retirement receipt of a single sum is another flaw in the 401(k) model of benefit accumulation. Since benefits are payable as a single sum at the time of termination of employment from a 401(k) plan, many employees eschew the opportunity to keep their money in a subsequent employer's retirement plan or IRA, even though there is a 10% tax penalty assessed when employees withdraw 401(k) assets prior to age 59 1/2.[49] In contrast, employees generally cannot receive any benefits prior to retirement age in a typical DB plan.[50]

These problems may result in a retirement savings shortfall for soon-to-be retirees, and could have a much more dramatic effect on later generations of retirees, especially if Social Security benefits are further reduced or delayed, as is currently anticipated.[51] Also, with employer-provided post-retirement medical plans in severe decline, another looming problem will be the extent of medical coverage provided under Medicare, particularly with health care costs rising dramatically each year.[52] Any shortfall in retirement benefits due to inadequate savings in 401(k) plans will be felt much more

49. *See* I.R.C. §§ 72(t)(2)(A)(i), 401(k)(2)(B)(i)(I) (2006); MUNNELL & SUNDÉN, *supra* note 10, at 5 ("About 45 percent of participants in 2004 cashed out when they changed jobs."); Kathleen Pender, *Employer Can Sign You Up for a 401(k) but it Has No Liability*, S.F. CHRON., Oct. 28, 2007, at C1 (citing Hewitt Associates study that two-thirds of 20-29 year olds that cease employment with an employer choose not to rollover their account balances); Copeland, *supra* note 37, at 6 fig.5 (indicating that 36% of employees who take a distribution from their 401(k) plan when they terminate use at least some of the proceeds to pay off debts, mortgages or other loans, and that 17% use at least some of the proceeds for immediate consumption).

50. *See supra* text accompanying note 32.

51. *See* MUNNELL & SUNDÉN, *supra* note 10, at 54 (indicating that Social Security will provide a lesser replacement rate of pre-retirement income in the future); *cf. '08 Resolutions: Look to Election, Iraq, Economy*, INV. BUS. DAILY, Jan. 2, 2008, at A1. [hereinafter *Resolutions*] (noting that Social Security's surplus is projected to turn into a deficit around 2017 and that it is projected to go bankrupt in 2041).

52. *See* Kris Hundley, *Grim View of Health Costs for Retirees*, ST. PETERSBURG TIMES, Mar. 6, 2008, at 4A, (indicating that a 65-year old couple retiring in 2008 will need $225,000 to cover medical costs for retirement according to a Fidelity study, up 41% from 2002); MUNNELL & SUNDÉN, *supra* note 10, at 54 ("Medicare part B premiums . . . are scheduled to rise from 7 percent to 10 percent of Social Security benefits."); Kathleen Day, *Retirement, Squeezed*, WASH. POST, Sept. 18, 2006, at F1 ("[A]n old rule of thumb that retirees need 75 percent to 85 percent of their pre-retirement income to live comfortably is outdated. A person today probably needs closer to 100 percent . . .

on the part of lower-paid employees, who will not have the private savings that their higher-paid peers will have available to fall back on.[53] Even in its current form, Social Security is "inadequate by itself to maintain the standard of living of any but the very poorest recipients."[54] All of this is occurring "at a time when increased life expectancy means that retirees have to stretch their retirement savings to cover longer periods of retired life, and when the decrease in the number of active employees relative to retired ones puts increasing strain on the Social Security system."[55]

As a result, lower-paid employees may have to postpone retirement indefinitely (assuming that they are fit to work and that there is demand for their skills), suffer through a poor standard of living in their retirement years, or become reliant on their family or friends to provide for them during their retirement years.[56] The eventual result may unfortunately be that "the government [and taxpayers will be] called upon to

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because people are living longer and they need to include money for health care not covered by Medicare.").

53. *See* Ken McDonnell, *Income of the Elderly Population Age 65 and Over, 2005*, *in* EBRI NOTES (Employee Benefits Research Inst.), May 2007, at 4 fig.4, *available at* http://www.ebri.org/pdf/notespdf/EBRI_Notes_05-2007.pdf (in 2005, the poorest quintile of Americans over age 65 collected 91% of its income from Social Security compared to 18% for the wealthiest quintile).

54. Nancy J. Altman, *Rethinking Retirement Income Policies: Nondiscrimination, Integration, and the Quest for Worker Security*, 42 TAX L. REV. 435, 494 (1987).

55. Susan J. Stabile, *Is it Time to Admit the Failure of an Employer-Based Pension System?*, 11 LEWIS & CLARK L. REV. 305, 306 (2007).

56. *See* Mark Bruno, *The 401(k) Effect: Employees Who Won't Retire*, FIN. WEEK, Mar. 7, 2008, *available at* http://www.financialweek.com/apps/pbcs.dll/article?AID=/20080307/REG/669934146 (noting that employees that depend primarily on DC plans for their retirement income are much less likely to retire than employees that depend primarily on DB plans for their retirement income). A greater dependence of retirees on their children and families for financial support would reflect a dramatic reversal of historical gains in the standard of living of the elderly. *See* Langbein, *supra* note 40, at 743 ("[T]oday's elderly no longer expect much financial support from their children."); DORA L. COSTA, THE EVOLUTION OF RETIREMENT: AN AMERICAN ECONOMIC HISTORY, 1880-1990, at 110 (1998) (noting that the percentage of retired males who live with their children has declined from 46% in 1880 to 22% in 1940 to 5% in 1990); JAMES H. SCHULZ, THE ECONOMICS OF AGING 38-39 (7th ed. 2001) (citing data that the poverty rate among the elderly has dropped from 30% in 1967 to 10% in 1997).

provide retirees with retirement income protection at a time when both Social Security and Medicare are projected to be unable to fund the full level of benefits now established by law."[57]

B. *Uninformed Investment Selections by Employees*

Another drawback of 401(k) plans is that employees often make uninformed investment choices. Many employees invest solely in money-market accounts or stable value funds that provide relatively low year-over-year returns.[58] This conservative investment strategy likely results from employers providing these types of funds as defaults.[59] Behavioral economic studies have shown that when employees are defaulted into a particular investment strategy, they assume that employers are recommending that particular investment strategy.[60]

Another type of employees who make uninformed investment choices are those who invest primarily or solely in company stock. A recent study by the Bureau of Labor Statistics concluded that 27% of 401(k) plan members participate in plans in which employer matching contributions are automati-

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57. Craig Copeland, *Lump-Sum Distributions, in* EBRI NOTES (Employee Benefits Research Inst.), December 2005, at 13, *available at* http://www.ebri.org/pdf/notespdf/EBRI_Notes_12-20055.pdf.

58. *See* Jack VanDerhei et al., *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2007,* 324 EBRI ISSUE BRIEF (Employee Benefits Research Inst.), Dec. 2008, at 29 fig.27, *available at* http://www.ebri.org/pdf/briefspdf/EBRI_IB_12a-2008.pdf (In 2007, 13.2% of all 401(k) plan participants and 19.2% of 401(k) plan participants in their 20s held no equities in their 401(k) holdings).

59. *See* James J. Choi, et al, *Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance,* 4 (Nat'l Bureau of Econ. Research, Working Paper No. 8655, 2001) ("[E]mployer choices of default savings rates and default investment funds strongly influence employee savings levels. Even though employees have the opportunity to opt out of such defaults, few actually do so.").

60. Jodi DiCenzo, *Behavioral Finance and Retirement Plan Contributions: How Participants Behave, and Prescriptive Solutions,* 301 EBRI ISSUE BRIEF (Economic Benefits Research Inst.), Jan. 2007, at 7, *available at* http://www.ebri.org/pdf/briefspdf/EBRI_IB_01-20071.pdf ("Behaviorists have posited that one reason participants exhibit default behavior is because they may interpret a plan's default rules as implicit advice.").

cally invested in employer stock.[61] The dangers inherent in this investment strategy were brought to the forefront by the Enron collapse in 2001. Enron employees had regularly invested their 401(k) assets in Enron stock, only to see their 401(k) accounts fall by 70-90% when Enron stock crashed.[62] For DB plans, ERISA limits the investment of employer stock to 10% of total plan assets in order to prevent this type of disaster scenario.[63] However, ERISA does not provide the same employer stock limitation in the DC context.[64] As a result, 401(k) plans are generally much more heavily invested in employer stock than DB plans.[65]

Nonetheless, employers have traditionally set the default account to which they provide matching contributions as either money-market accounts, stable value funds or company stock, putting the burden on employees to immediately transfer their assets into better diversified funds.[66] With many rank-

61. William J. Wiatrowski, *401(k) Plans Move Away From Employer Stock as Investment Vehicle*, MONTHLY LABOR REVIEW 3, 7 Nov. 2008, http://www.bls.gov/opub/mlr/2008/11/art1full.pdf.

62. *See* Susan J. Stabile, *Enron, Global Crossing, and Beyond: Implications for Workers*, 76 ST. JOHN'S L. REV. 815, 824 (2002); Richard A. Oppel, Jr., *Employees' Retirement Plan is a Victim as Enron Tumbles*, N.Y. TIMES, Nov. 22, 2001, at A1.

63. *See* ERISA § 407(a)(2), 29 U.S.C. § 1107(a)(2) (2006).

64. ERISA § 407(b), 29 U.S.C. § 1107(b) (providing that the 10% limit doesn't apply to an individual account plan in which plan participants direct investments). Although the Enron experience exposed the pitfalls that result from overinvesting in company stock under a 401(k) plan, the problem is still present today. *See, e.g.*, Eileen Ambrose, *Workers Still Filling 401(k)'s With Company Stock*, CHI. TRIB., Oct. 7, 2007, at 5 (one-third of Countrywide Financial Corp.'s 401(k) assets at the end of 2007 were invested in company stock). Some critics have argued that it does not make sense that the 10% limitation applies to DB plans but not DC plans. *See* LANGBEIN, STABILE & WOLK, *supra* note 17, at 640 ("It is astonishing to see . . . that the drafters of ERISA, having so insistently imposed the duty to diversify on [DB plans] . . . then waived that requirement for [DC plan] investments in employer securities . . . ."); ZELINSKY, *supra* note 42, at 160-61 ("It is . . . anomalous that the ten percent limit on employer stock does not apply to [DC] plans.").

65. *Compare* VanDerhei et al., *supra* note 58, at 25 fig.22 (14.5% of 401(k) plans with more than 5,000 participants were invested in employer stock during 2007) *with* Douglas Appell, *Asset Allocation: Defined Benefit Plans Reap Harvest of Equity Markets*, PENSION & INVESTMENTS, Jan. 26, 2004, at 22 fig.Average Asset Mix of the Top 1,000 Plans (1.5% of DB plan assets of the 1,000 largest DB plans in 2003 were invested in employer stock).

66. *Compare* MUNNELL & SUNDÉN, *supra* note 10, at 6 ("[M]ore than half of [401(k)] plans use stable value funds or money market funds as the de-

and-file employees unable to make an informed investment decisions when offered mutual funds by their employers' 401(k) plans between these two extremes, these employees often punt on the decision and never bother to reallocate their 401(k) assets at all.[67] As a result, employees' overall 401(k) plan assets are not appropriately diversified and accordingly, experience has shown that their returns have not performed as well as they would have under a DB plan.[68]

C. *Modest Plan Participation Due to Requirement to "Opt In" to Plan*

A related problem has been the low level of employee participation in 401(k) plans as compared to DB plans. In the DB plan setting, eligible employees do not have the option

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fault investment option for automatic deferrals. These funds are safe investments, but as such, they produce low returns") *and* Megan Johnston, *401(k) Rule to Spark Risk-Return Scramble; Conservative Vehicles Out as Default Options, Forcing Employers to Search for Replacements,* FIN. WEEK, Oct. 29, 2007, *available at,* http://www.financialweek.com/apps/pbcs.dll/article?AID=/20071029/REG/71026042/1028 (cites 2006 Watson Wyatt study that 45% of 401(k) plans use stable value funds or money market funds as the default investment option), *with* Jim Davenport, *When All the Eggs Are in the Company Basket: With a 401(k), Employees' Retirement Plans Rise and Fall with Stock's Value,* CHI. TRIB., Aug. 14, 1995, at 3 (citing a Buck Consultants report that 18% of all companies surveyed and 40% of the largest companies surveyed matched employee 401(k) contributions with employer stock) *and* HEWITT ASSOCIATES, *supra* note 7, at 3 ("[A]mong plans that offer employer stock as an investment option, [23%] invest the employer matching contribution exclusively in employer stock. This is down from 36% in 2005 and 45% in 2001."). *See also* Eileen Ambrose, *Don't Let Stock in Employer Build Up,* BALT. SUN, Sept. 30, 2007, at 1C (noting that one reason given for the sudden drop in defaulting employer stock as matching contributions is employers' fear of employee lawsuits).

67. *See* Jessica Marquez, *The Default Dilemma: Part 1 of 2,* WORKFORCE MGMT., Aug. 20, 2007, at 41 (according to Vanguard, 80% of 401(k) plan participants never modify their initial investments).

68. *See* ALICIA H. MUNNELL ET AL., CTR. FOR RET. RESEARCH AT BOSTON COLL., INVESTMENT RETURNS: DEFINED BENEFIT VS. 401(K) PLANS 3 (Sept. 2006), http://crr.bc.edu/images/stories/Briefs/ib_52.pdf (noting that from 1988-2004, DB plan returns exceeded 401(k) plan returns by about 1% per year). *Cf.* MUNNELL & SUNDÉN, *supra* note 10, at 5 ("[A] typical worker who ends up at retirement with earnings of $58,000 and who contributed 6 percent steadily with an employer match of 3 percent should have about $380,000. . . . In 2004, the median balance for household heads aged 55-64 was $60,000.").

whether or not to participate in the plan—they automatically become participants of a plan at the later of the time they turn 21 or complete one year of service with their employer.[69]

However, in the 401(k) setting, employees generally must affirmatively enroll in order to participate in the plan.[70] Non-participation among employees who are eligible to join their employers' 401(k) plans from 2004 through 2006 was about 60-70% for new employees and 21% for all employees.[71] Not surprisingly, the percentages are even worse for younger, low-paid employees—participation for employees under 40 who earn less than $50,000 per year is only about 50%.[72] This structure of plan participation, with high participation of highly-paid employees and low participation for lower-paid employees was partly what Congress sought to avoid in various provisions of ERISA.[73] The most cited reasons for employees' failure to affirmatively enroll, according to one study, are a lack of financial education and procrastination.[74] Additionally, behavioral economists have suggested that some employees do not enroll when they are hired because they interpret a plan's non-participation default as implicit advice that they should not participate.[75] Thus, low plan participation may be more related to procrastination and/or confusion as opposed to a

69. ERISA § 202(a)(1)(A), 29 U.S.C. § 1052(a)(1)(A) (2006).

70. *See* MUNNELL & SUNDÉN, *supra* note 10, at 6; BLS SURVEY, *supra* note 32 at 109 tbl.88 (Jan. 2005) (95% of plans in 2002 did not automatically enroll participants into 401(k) plans).

71. *See* MUNNELL & SUNDÉN, *supra* note 10, at 3; Eileen Ambrose, *Automatic Enrollment in 401(k) has Striking Effect*, BALT. SUN, Oct. 8, 2006, at 1C.

72. *See* Holden & VanDerhei, *supra* note 40, at 9 fig.4.

73. *See* Bruce Wolk, *Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality*, 70 VA. L. REV. 419, 433 (1984) ("Congress has chosen to pay a tax subsidy to high bracket employees to induce employers to establish plans also covering low bracket employees."); H.R. REP. NO. 99-426, at 687 (1985) ("Because the committee believes that a basic reason for extending significant tax incentives to qualified pension plans is the delivery of comparable benefits to rank-and-file employees who may not otherwise save for retirement, the committee concludes that it is appropriate to revise the nondiscrimination rules . . . in order to more closely achieve this goal.").

74. *See* DiCenzo, *supra* note 60, at 7; JULIE R. AGNEW ET AL., CTR. FOR RET. RESEARCH AT BOSTON COLL., DO FINANCIAL LITERACY AND MISTRUST AFFECT 401(K) PARTICIPATION? 3-4 (Nov. 2007), http://crr.bc.edu/images/stories/Briefs/ib_7-17.pdf.

75. *Cf.* DiCenzo, *supra* note 60, at 7.

lack of willingness or inability to contribute on the part of employees.[76] Because of long periods of interest compounding, employees that do not begin contributing at young ages significantly undermine their eventual retirement benefits.[77]

To illustrate how this can have significant repercussions, take the example of a 25 year old employee who earns $50,000 annually and whose employer sponsors a 401(k) plan that provides for 100% employer-matching contributions up to 3% of salary. If this employee contributes a mere 3% of her salary into the plan, she will contribute $3,000 into the plan for that year ($1,500 from the employee and $1,500 from the employer). If her 401(k) account earns approximately 7% per year from the time she is 25 until the time she retires at 65, that single $3,000 contribution will be worth *$44,923* at the time she retires. Thus, delaying 401(k) plan participation for as little as one year can have dramatic consequences upon total retirement savings.

Another illustration of the repercussions that delayed 401(k) plan participation can create is from a recent study by the American Society of Pension Professionals & Actuaries (ASPPA). Employees who begin contributing to a 401(k) plan at age 35 must contribute an additional 7% of compensation per year in order to wind up with the same age 65 benefits as those employees who began contributing at age 25.[78]

III.
AUTOENROLLMENT

A. *Overview*

Employers can rectify the problem of poor employee participation by adopting the autoenrollment feature as part of a

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76. *See* DiCenzo, *supra* note 60, at 7; AGNEW, *supra* note 74, at 3-4; MUNNELL & SUNDÉN, *supra* note 10, at 53 ("Procrastination and inertia emerge as important explanations [ ] for lack of participation in 401(k) plans.")

77. *See* Turpin & White, *supra* note 27, at 2.

78. *Id.* Although the Internal Revenue Code currently allows participants 50 and older to contribute "catch-up contributions" on a tax-preferred basis in order to assist those employees who began contributing later in their careers, *see* I.R.C. § 414(v) (2006), only 13% of those participants did so, and for the most part, those who took advantage of catch-up contributions are earning six-figure salaries or have spouses with substantial incomes, *see* Turpin & White, *supra* note 27, at 3.

401(k) plan. Autoenrollment means what it suggests—employees become participants in a 401(k) plan at the time they are hired, with contributions beginning immediately. Thus, an employee must affirmatively opt out of the plan, rather than affirmatively opt in.

Autoenrollment was originally permitted by the IRS via Revenue Rulings in 1998 and 2000.[79] The Pension Protection Act of 2006[80] (PPA) assisted the movement towards autoenrollment by allowing employers to utilize an autoenrollment provision in their 401(k) plans in order to avoid certain nondiscrimination requirements otherwise mandated by the IRS.[81] Shortly thereafter, the Department of Labor (DoL) promulgated regulations that provide the types of investment funds into which plan contributions can be automatically invested.[82]

B. *History of Autoenrollment Prior to the PPA*

Prior to the PPA and subsequent DoL regulations, employers had been reluctant to automatically enroll employees in 401(k) plans for a number of reasons. First, employers were nervous about potential legal liability if any automatic investments performed poorly.[83] Also, many states have wage garnishment statutes that prevent employers from withholding employee wages without written consent.[84] As a result, many companies were reluctant to offer autoenrollment, fearing that autoenrollment would violate these statutes.[85] Lastly, employers didn't have the incentive to offer autoenrollment because of additional costs (both directly to the plan by way of additional contributions and indirectly by way of additional ad-

79. Rev. Rul. 98-30, 1998-1 C.B. 1273; Rev. Rul. 2000-8, 2000-1 C.B. 617.

80. Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (2006).

81. *See* I.R.C. § 401(k)(13).

82. 29 C.F.R. § 2550.404c-5 (2008).

83. *See* DiCenzo, *supra* note 60, at 4 ("[T]he risk of plan sponsors' potential legal liability for participants' investment losses has been a major obstacle to the greater use of automatic enrollment . . . .").

84. *See, e.g.*, CAL. LAB. CODE § 300(b) (West 2003).

85. *See* LANGBEIN, STABILE & WOLK, *supra* note 27, at 37; Pender, *supra* note 49, at C1.

ministrative costs) inherent in automatically enrolling employees.[86]

A handful of employers had provided for autoenrollment beginning with the IRS's Revenue Rulings in 1998 and 2000, but with mixed experiences. Some employers, understandably nervous about being susceptible to liability if they invested employee assets in funds that decreased in value, automatically enrolled employees in money-market accounts or stable value funds that provided very low, but non-negative, returns.[87] McDonald's was one of the first prominent employers to provide autoenrollment for their employees and it was successful to the point that its 401(k) plan achieved 93% participation in 2002.[88] However, McDonald's abandoned autoenrollment shortly thereafter for various reasons including the high administrative costs that resulted from opening many small accounts and a change in law which enabled the company to satisfy nondiscrimination requirements without an autoenrollment feature.[89]

C. *Post-PPA Autoenrollment*

In response, the PPA now "make[s] an automatic enrollment arrangement a desirable feature for a 401(k) plan."[90] The PPA encourages employers to adopt autoenrollment by providing a safe harbor which allows plan sponsors to avoid annual compliance with the actual deferral percentage test (ADP test) and/or the actual contribution percentage test

86. *See id.*

87. *See* J. Alex Tarquinio, *In Search of Savers: 401(k) Rules are Changing*, N.Y. TIMES, Nov. 11, 2007, § 3, at 5 ("[M]ost companies [previously] put auto-enrolled employees into money market accounts or equivalent investments, where capital preservation was guaranteed. . . . [E]mployers did not want to be sued if such employees were put into portfolios that lost money.").

88. Kathleen Pender, *Automatic Enrollment in 401(k)*, S.F. CHRON., Aug. 8, 2006, at D1.

89. *See id.*; I.R.C. § 401(k)(12) (2008) (providing design-based safe harbor for 401(k) plans).

90. Stanley D. Baum, *Proposed Rules on Automatic Enrollment Arrangements for Salary Reduction Plans*, 108 J. TAX'N 33, 42 (2008) (discussing the statutory law pertaining to autoenrollment as provided under the Internal Revenue Code, ERISA and Treasury Regulations).

(ACP test).[91] The ADP test and ACP test are designed to ensure that 401(k) plans do not provide inordinate benefits to highly compensated employees, defined in 2009 as those who own at least 5% of the employer and earn at least $110,000 per year, as compared to non-highly compensated employees.[92] However, so long as a 401(k) plan meets three requirements—automatic deferral, matching or nonelective contributions and notice—the plan qualifies for the safe harbor and does not have to annually complete the ADP and ACP tests.[93] The Internal Revenue Code refers to a 401(k) plan that provides an autoenrollment safe harbor as a "qualified automatic contribution arrangement" (QACA).[94]

Safe harbor designs are popular among employers in 401(k) plans because they make administration of such plans simpler and offer more predictability.[95] In 2000, the first design-based safe harbor became effective, providing that 401(k) plans did not have to annually perform ADP or ACP tests so long as they provided nonelective contributions of at least 3% of a participant's compensation per year or matching contributions of 100% of the first 3% participant's elected contributions and 50% of the next 2% of contributions.[96] In a 2007 survey, 29% of employers said that they used a design-based safe harbor in their 401(k) plans in lieu of annual ADP and

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91. *See* I.R.C. §§ 401(k)(13), *See generally* I.R.C. §§ 401(k)(3)(A)(ii) (providing two different ways in which a 401(k) plan can pass the ADP test: either, 1) the average deferral percentage for eligible highly compensated employees must be less than 1.25 times the average deferral percentage for all other eligible employees in the preceding year *or* 2) the average deferral percentage for highly compensated employees must be less than 2% more than, and not more than double, the average deferral percentage for other eligible employees in the preceding year), 401(m)(2)(A) (providing a similar test for employer matching contributions).

92. *See* I.R.C. §§ 401(k)(3)(A)(ii), (m)(2)(A), 414(q)(1) (defining highly compensated employee); *see also* I.R.S. News Release IR-2008-118, 2008 WL 4591411 (Oct. 16, 2008) (announcing that the cut-off compensation for determining a highly-compensated employee for 2009 is $110,000).

93. I.R.C. § 401(k)(13).

94. *Id.* § 401(k)(13)(B).

95. *See* LANGBEIN, STABILE & WOLK, *supra* note 17, at 428 ("The ADP test for 401(k) plans is complex and costly. An employer must do the record keeping necessary to monitor employee elections, perform the required calculations to apply the test, and administer the correction mechanism."); *see also* HEWITT ASSOCIATES, *supra* note 7, at 5.

96. I.R.C. § 401(k)(12)(B)(i), (C).

ACP testing.[97] Employers that currently utilize the prior design-based safe harbor will likely find the autoenrollment form of safe harbor to be an attractive alternative.

The automatic deferral requirement of the new safe harbor mandates that employees contribute a "qualified percentage" of compensation, defined as at least 3% in the first plan year of participation, at least 4% in the second plan year of participation, at least 5% in the third plan year of participation, and at least 6% in any subsequent year.[98] However, the percentage cannot exceed 10% in any year.[99] This plan feature, which increases contributions automatically in this fashion, is referred to as "auto-escalation".[100]

Similar to the earlier safe harbor design, a 401(k) plan can provide either a matching contribution or a nonelective contribution in order to qualify as a QACA. The matching contribution requirement mandates that an employer must provide a matching contribution of 100% of the first 1% of employee contribution and 50% of any further employee contributions, with a maximum employee deferral percentage of 6% of compensation.[101] Alternatively, a plan can provide a nonelective contribution of at least 3% of compensation, no matter the percentage of compensation that employees elect to defer.[102] Whether the plan provides for matching or nonelective contributions, these contributions must be 100% vested after an employee has completed two years of service with the employer.[103] This is a shorter vesting period than the otherwise-permissible three years that can be provided for employer contributions in typical 401(k) plans.[104]

Lastly, a 401(k) plan with an autoenrollment feature must comply with a notice requirement in order to be a QACA.[105]

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97. *See* HEWITT ASSOCIATES, *supra* note 7, at 5.

98. I.R.C. § 401(k)(13)(C)(iii) (2008).

99. *Id.*

100. *See* Barbara Rose, *Employers Push Workers to Save*, CHI. TRIB., Apr. 30, 2007, at C2 ("auto-escalation features [step up] contributions annually").

101. I.R.C. § 401(k)(13)(D)(i)(I).

102. *Id.* § 401(k)(13)(D)(i)(II).

103. *Id.* § 401(k)(13)(D)(iii)(I).

104. *See* ERISA § 203(a)(2)(B)(ii), 29 U.S.C. § 1053(a)(2)(B)(ii) (2006).

105. I.R.C § 401(k)(13)(E) (2008). *See also id.* § 414(w)(4) (providing the same notice requirements for all forms of automatic contribution arrangements, even if not qualified or part of a 401(k) plan); ERISA § 404(c)(5)(B), 29 U.S.C. § 1104(c)(5)(B) (2008) (providing similar notice requirements

The notice must provide each employee with his or her rights and obligations under the plan within a "reasonable period" before each plan year.[106] The notice must be written in a manner that an average employee will understand, the same requirement that ERISA imposes upon summary plan descriptions that must be furnished to plan participants.[107] The notice must explain that each employee has the right to elect *not* to have automatic contributions made on his or her behalf and it must describe how contributions will be invested if the employee does not make an election.[108] Each employee must be given a "reasonable period" of time after receipt of the notice before the first contribution is made on his or her behalf.[109]

Additionally, the PPA expressly provides that any 401(k) plan that offers a QACA will supersede any state law that would restrict such an arrangement, such as a wage garnishment law.[110] The PPA permits an employee to opt out of plan participation within 90 days of the first automatic contribution that is deposited without any negative financial or tax consequences.[111] The PPA additionally provides that plan sponsors

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for plan sponsors to avoid fiduciary liability under ERISA where employee contributions are automatically invested); ERISA § 514(e)(3), 29 U.S.C. § 1144(e)(3) (2008) (providing similar notice requirements for plan sponsors in order to preempt any otherwise-applicable state wage garnishment laws); Treas. Reg. § 1.401(k)-3(d)(3)(ii) (2006) (Treasury regulations providing more refined notice requirements, including the safe harbor matching and/or nonelective contributions provided for under the plan and guidance to employees regarding how to find additional information about the plan).

106. I.R.C. § 401(k)(13)(E)(i) (2006). Treasury regulations provide as a safe harbor rule that the timing requirement will be met if notice is given between 30 and 90 days prior to the beginning of the plan year. Treas. Reg. § 1.401(k)-3(d)(3)(ii) (2006).

107. *Id.* § 401(k)(13)(E)(i)(II), ERISA § 102(a), 29 U.S.C. § 1022(a) (2006). But note that providing a summary plan description in and of itself does not suffice as sufficient QACA notice. *See* Prop. Treas. Reg. § 1.401(k)-3, 72 Fed. Reg. 63,144, 63,147 (Nov. 8, 2007).

108. I.R.C. § 401(k)(13)(E)(ii)(I)-(II) (2006).

109. *Id.* § 401(k)(13)(E(ii)(III).

110. ERISA § 514(e)(1), 29 U.S.C. § 1144(e)(1). *See also* 29 C.F.R. § 2550.404c-5(f)(1)-(2) (2007) (DoL regulations reiterate federal preemption over state wage garnishment laws).

111. I.R.C. §§ 414(w)(2), 414(w)(1)(B) (2006) (providing that the 10% penalty tax doesn't apply in this situation). *See also* Prop. Treas. Reg. § 1.414(w)-(1)(c), 72 Fed. Reg. 63,144, 63,154 (Nov. 8, 2007) (providing

will be protected from any fiduciary liability so long as "default investments. . . include a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both."[112] With regard to what types of investments fit that profile, the PPA expressly defers to regulations promulgated by the DoL, which are summarized below.[113]

D. *Autoenrollment Default Funds Under DoL Regulations*

The relevant DoL regulations provide that 401(k) plans may automatically enroll participants into one of three qualified default investment alternatives (QDIAs).[114] The first type of QDIA permitted under the DoL regulations is referred to as a "life-cycle" or "targeted-retirement date" fund.[115] This type of fund is typically categorized by a mix of equities and fixed income.[116] As an employee ages, the fund modifies its allocation to reduce equity exposure and increase fixed income exposure, thus providing higher returns for younger employees while lessening risk of loss for older employees.[117] Thus far, employers appear to prefer life-cycle funds the most out of the three choices.[118]

The second type of QDIA is referred to as a "balanced" fund.[119] This fund is similar to the life-cycle fund in that it invests in a mix of equities and fixed income.[120] However, a balanced fund does not reallocate assets based on age as a life-

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that employees who elect to withdraw their contributions within 90 days will receive in cash the amount that was contributed on their behalf reflecting any gains or losses that accrued under the plan from the contribution date through the date of withdrawal and reflecting any fees that were assessed against such investments under the typical operation of the plan).

112. ERISA § 404(c)(5)(A), 29 U.S.C. § 1104(c)(5)(A) (2008).

113. I.R.C. § 414(w)(3)(C) (2006).

114. 29 C.F.R. § 2550.404c-5(e) (2008).

115. *Id.* § 2550.404c-5(e)(4)(i) (2008).

116. *Id.*

117. *Id.*

118. *See* HEWITT ASSOCIATES, *supra* note 7, at 3 (noting that 50% of employers that automatically enroll employees have chosen to default contributions into "target-date" funds); Marquez, *supra* note 67, at 41 (noting that one survey of companies that utilize an auto-enrollment feature showed that 71% of plan sponsors are looking to use a life-cycle fund as a default in the future).

119. 29 C.F.R. § 2550.404c-5(e)(4)(ii) (2008).

120. *Id.*

cycle fund would, so the same asset allocation will apply to all participants in a plan, typically along the lines of a 60-40 ratio of stocks to bonds.[121]

The third type of QDIA is known as a "managed fund".[122] This fund is actively managed by an investment management service and allocates assets based on a participant's age, target retirement date, and/or life expectancy.[123] As a result, this fund will adjust allocations based on the age of an employee, similar to a target-date fund.[124] However, because this type of QDIA is actively managed, the associated 401(k) fees are likely to be higher than the other two QDIAs.[125]

As long as 401(k) plans autoenroll employees into one of the three QDIAs, the DoL regulations and ERISA provide that employers will not be liable as fiduciaries in the event that the funds lose value.[126] Nonetheless, employers still have the fiduciary duty to "prudently select and monitor any [QDIA offered] under the plan" and will be liable to employees for any resulting losses for failure to select and monitor accordingly.[127] Additionally, ERISA and the DoL regulations provide that an employer will avoid any fiduciary liability related to poor experience of default investments so long as adequate notice is given to employees.[128] The notice requirements are

121. *Id.*

122. *Id.* 29 C.F.R. § 2550.404c-5(e)(4)(iii) (2008).

123. *Id.*

124. *Id.*

125. *See* Eleanor Laise, *Employers Grab Reins of Workers' 401(k)s—To Spur Savings, Companies Adopt Automatic Enrollment, Steer Investments, Boost Employee Contributions; the Opt-Out Option*, WALL ST. J., Apr. 25, 2007, at D1 ("[M]anaged accounts . . . often tack on additional fees, usually a fraction of a percentage point, on top of the expenses of the underlying fund holdings."). Note that additional fees of 1% can reduce an employee's 401(k) returns by 15% over 30 years. *See* Darrell Preston & Gary Matsumoto, *Fees on 401(k)s Rock Boomers Facing Flawed Dislcosure*, BLOOMBERG.COM, Jan. 29, 2008, http://www.bloomberg.com/apps/news?pid=20601213&sid=aSsfSnH.bIds&refer=home.

126. *Id.* § 2550.404c-5(b)(1); ERISA § 404(c)(5)(A), 29 U.S.C. § 1104(c)(5)(A) (2006).

127. 29 C.F.R. § 2550.404c-5(b)(2).

128. *Id.* § 2550.404c-5(d), ERISA 404(c)(5)(B), 29 U.S.C. § 1104(c)(5)(B); *id.* § 2550.404c-5(d). *See also* Default Investment Alternatives Under Participant Directed Individual Account Plans, 72 Fed. Reg. 60,452, 60,467 (Oct. 24, 2007) (to be codified at 29 C.F.R. § 2550) ("Plan fiduciaries must take into account potential conflicts of interest and the reasonableness of

generally similar to those discussed previously with regard to establishing a QACA, except that the QDIAs must be described in some detail, "including a description of the investment objectives, risk and return characteristics. . . and fees and expenses attendant" and participants must be told where they can obtain information regarding other investments provided by the plan.[129]

E. *Results Thus Far*

Since the passage of the PPA and promulgation of the DoL regulations, large employers have responded favorably to autoenrollment.[130] As of 2007, 34% of large employers now offer autoenrollment according to one study and the DoL projects that, with the regulations finalized, that percentage will grow to 50-65% in the near future.[131] Financial institutions are leading the lobbying charge for an autoenrollment standard, as they stand to earn higher fees based on greater enrollment and larger account balances.[132]

F. *Positive Aspects of Autoenrollment*

1. *Curing Employee Inertia*

Studies to date suggest that autoenrollment will solve some employee inertia problems discussed above, particularly with regard to procrastination.[133] In fact, the DoL believes that

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fees in choosing and monitoring any investment option for a plan, whether covered under the safe harbor or not. . . . [T]he duty to evaluate a plan investment exists regardless of whether the plan includes an automatic enrollment feature or whether the fiduciary is seeking to comply with this regulation.").

129. 29 C.F.R. § 2550.404c-5(d)(3), 5(d)(5).

130. *See* Jerry Geisel, *Auto Enrollment Rules Seen as 401(k) Boost; Employers Given Set Investment Options*, BUS. INS., Oct. 29, 2007, at 3 (noting that Dow Chemical Co., Goodyear Tire & Rubber Co., IBM Corp. and Lincoln Financial Corp. have all introduced autoenrollment into their plans).

131. HEWITT ASSOCIATES, *supra* note 7, at 3; Default Investment Alternatives Under Participant Directed Individual Account Plans, 72 Fed. Reg. at 60,470 n.24; Johnston, *supra* note 63.

132. *See* Laise, *supra* note 125, at D1 (noting that Charles Schwab and Wachovia are urging employers to move employees' 401(k) assets into QDIAs and that T. Rowe Price recently introduced a feature that automatically boosts employee contributions to the level needed to get the full company match).

133. *See, e.g.*, DiCenzo, *supra* note 60, at 15.

an autoenrollment feature could lead nonparticipation in a 401(k) plan to drop below 10%.[134] This is notable because it is very easy for employees to opt out of autoenrollment under the current law by simply sending in a form within ninety days of the first contribution made on their behalf.[135] The low opt-out rates under autoenrollment experienced thus far (between 1 and 9 percent) suggest that employee inertia may be the true reason for low 401(k) plan participation rates.[136]

By helping to solve the problem of employee inertia, the hope would be that autoenrollment would give employees an appropriate starting perspective of an expert's view of a well-allocated, diversified investment portfolio. Once employees become participants in a 401(k) plan, they will then have the additional incentive to monitor how their investments are performing and make determinations whether to make any modifications based on returns to date or personal risk preferences.[137] Alternatively, employees can just as easily choose not to monitor or reallocate; because the default allocations are well-diversified, they are likely to earn sufficient retirement benefits without acting.[138]

2. *Diversified Default Investments*

The QDIAs are advantageous for plan participants, particularly younger employees, low-paid employees and/or those who change jobs frequently who might not have otherwise en-

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134. *See* Default Investment Alternatives Under Participant Directed Individual Account Plans, 72 Fed. Reg. 60,452, 60,474 n.39 (Oct. 24, 2007) (to be codified at 29 C.F.R. pt. 2550).

135. *See* I.R.C. §§ 401(k)(13)(C)(ii), 414(w)(2)(B) (2008).

136. *See* Kathryn Glass, *Auto Enrollment Makes 401(k)s Easy, But Experts Say It's Not Enough*, FOXBUSINESS, Feb. 29, 2008, http://www.foxbusiness.com/story/markets/economy/auto-enrollment-makes-ks-easy-experts-say (one expert indicated that only 1% to 9% of employees opt out of autoenrollment).

137. *See* Default Investment Alternatives Under Participant Directed Individual Account Plans, 72 Fed. Reg. at 60,474 ("Default participation might foster financial literacy or a taste for saving, which could augment the [DoL] regulation's effect.").

138. Employers with this point of view of their employees would likely prefer life-cycle funds or managed funds. *See* Marquez, *supra* note 67, at 43 ("[M]any companies like [a life-cycle] fund because it doesn't require plan participants to do anything. . . . If [participants] never look at their investments again, at least they are in the proper asset allocation.")

rolled in a 401(k) plan.[139] The importance of a proper default investment is indicated by a Vanguard study which reveals that 80% of 401(k) plan participants never modify their initial investment allocation during the course of their plan participation.[140]

Thus, by incorporating QDIAs into an autoenrollment scheme, participants are initially invested in a diversified portfolio.[141] This mirrors the DB diversification approach, which is mandated as part of an employer's fiduciary duties under ERISA.[142] Therefore, by defaulting participants into QDIAs, autoenrollment pushes plan participants to invest their assets in a similar fashion as a DB plan trust.

G. *Downsides of Autoenrollment*

1. *Risk of Participant Losses (and Employer Liability) via QDIAs*

Although autoenrollment may be beneficial for 401(k) plan participants, there are some drawbacks that deserve attention. One drawback that has become readily apparent recently is that employees who are automatically enrolled become susceptible to downturns in financial markets, thus increasing the

139. *See* Default Investment Alternatives Under Participant Directed Individual Account Plans, 72 Fed. Reg. at 60,466 ("[As a result of the DoL regulation], [d]efault investments will be directed toward higher-return portfolios, boosting average investment returns. . . . [This] will increase average retirement savings, especially among workers who are younger, have lower earnings and/or more frequent job changes."); Holden & VanDerhei, *supra* note 40, at 19 ("Lower income individuals benefit the most from automatic enrollment.").

140. Marquez, *supra* note 67. *See also* James J. Choi, et al., *For Better or For Worse, Default Effects and 401(k) Savings Behavior*, NBER WORKING PAPER 8651, Dec. 2001, at 5 ("Under automatic enrollment, 65—87% of new plan participants save at the default contribution rate and invest exclusively in the default fund.").

141. *See* DAVID F. SWENSEN, UNCONVENTIONAL SUCCESS: A FUNDAMENTAL APPROACH TO PERSONAL INVESTMENT 16-20 (2005) ("The act of diversification provides a free lunch of enhanced returns and reduced risk, increasing the likelihood that an investor will stay the course in difficult market environments.").

142. *See* ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C) (2006) ("A fiduciary shall discharge his duties with respect to a plan . . . by diversifying the investments of the plan so as to minimize the risk of large losses . . ."); Meyer v. Berkshire Life Ins. Co., 250 F. Supp. 2d 544, 565 (D. Md. 2003) (court found a breach of fiduciary duty when DB plan sponsor admitted that it did not diversify its investments).

risk of losing money in a 401(k) plan. Since the enactment of PPA and promulgation of DoL regulations, QDIAs have not performed well due to the subsequent recession.[143] Despite the recent market downturn, QDIAs should still provide for greater retirement assets than investment in money-market and/or stable-value funds would over the course of an entire working career.[144] Nonetheless, impatient or risk-averse employees who experienced very poor asset performance during this period may react haphazardly by shifting their investments into money-market or stable-value funds or, worse, opt out of plan participation altogether.[145]

The DoL regulations were generally designed such that employers would avoid legal liability in the event that employees experienced losses in their retirement savings from QDIAs in which they were automatically enrolled.[146] Nonetheless, employers still may be liable if they ignore their fiduciary duty to monitor fund offerings appropriately.[147] 401(k) plan sponsors are increasingly including life-cycle funds as an investment option and/or QDIA in their plans, but these types of funds have

143. *See* Eleanor Laise, *Big Slide in 401(k)s Spurs Calls for Change*, WALL ST. J., Jan. 8, 2009, at A.12 (noting that the average target-date fund dropped 32% in 2008). From October 24, 2007, the date of issuance of the DoL regulations through January 7, 2009, the Dow Jones Industrial Average declined by 36% and the S&P 500 declined by 40%.

144. *See* Default Investment Alternatives Under Participant Directed Individual Account Plans, 72 Fed. Reg. at 60,471 tbl.2 (Under the DoL's conservative estimate, the PPA and DoL regulations related to autoenrollment and QDIAs will result in 1.6 million participants to be better off by an aggregate amount of $1.3 billion while 589,000 participants will be worse off by an aggregate amount of $328 million.); Holden & VanDerhei, *supra* note 40, at 15 fig.10 (A 2005 Economic Benefits Research Institute study determined that autoenrollment into a life-cycle fund as opposed to a money-market fund leads to salary replacement of an additional 5-7%).

145. *See* Laise, *supra* note 143, at A.12 (citing Hewitt Associates study which indicated that participants shifted 5.7% of plan assets in 2008, up from 3.3% in 2007, most of which was shifted into cash and stable-value funds). *Cf.* DiCenzo, *supra* note 60, at 13 (noting that 401(k) plan participants generally factor in past performance heavily when selecting investments).

146. *See* Default Investment Alternatives Under Participant Directed Individual Account Plans, 72 Fed. Reg. at 60,453-54 (providing fiduciary relief to plans that invest assets on behalf of participants whose assets are invested in QDIAs). *See also* Tarquinio, *supra* note 87.

147. *See supra* note 126.

only been around for a short period of time.[148] Thus, if some of these funds perform poorly, employers run the risk of facing employee lawsuits alleging that they did not abide by their fiduciary duty to select and monitor proper investment choices. In all likelihood, such lawsuits would not succeed, but any employers adopting autoenrollment must monitor how their QDIA offerings perform nonetheless.

On a similar note, employers should monitor and disclose the fees charged by the providers of any life-cycle funds and/ or managed accounts provided for in their 401(k) plans, as there has been recent litigation and discussions in Congress and the DoL regarding monitoring excessive 401(k) fees.[149]

2. *Increased Plan Costs*

Another drawback of autoenrollment is increased costs on the part of employers. The primary additional cost is larger employer matching or nonelective contributions resulting from increased plan participation. If an employer that provides matching contributions previously had low participation in its plan, the increased costs attributable to additional matching contributions could be substantial.[150] However, even if there are additional costs attributable to employer matching contributions, they will not nearly approximate the costs of DB plans and will be much more predictable than DB plan costs.[151] Nonetheless, increased costs have to be a concern for

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148. Marquez, *supra* note 67, at 43 (noting that few life-cycle funds have track records of more than 3-5 years, which makes them difficult for plan sponsors to evaluate and compare).

149. *See, e.g.,* Taylor v. United Techs. Corp., 2007 WL 2302284 (D. Conn. 2007). *See also* 401(k) Fair Disclosure for Retirement Security Act of 2007, H.R. 3185, 110th Cong. (2007), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:h3185ih.txt.pdf; Fee and Expense Disclosures to Participants in Individual Account Plans, 72 Fed. Reg. 20,457 (Apr. 25, 2007) (to be codified at 29 C.F.R. § 2550).

150. *See* Mark Bruno, *Tab for 401(k) Matches Has Many Bosses Steering Clear of Auto Enrollment,* FIN. WEEK, Mar. 3, 2008 (a 2007 Hewitt Associates study revealed that the cost of making additional matching contributions was the main reason that employers were reluctant to adopt autoenrollment). Default Investment Alternatives Under Participant Directed Individual Account Plans, 72 Fed. Reg. at 60,473 (DoL acknowledges that some employers will choose not to adopt autoenrollment because of increased costs attributable to increased employer contributions).

151. *See generally* Section I.C, *supra.*

employers in the current economic environment, especially since a few employers have recently suspended 401(k) matching contributions.[152]

In addition to increased costs from employer contributions, administrative expenses will also be higher as a result of autoenrollment. Autoenrollment may thus become expensive for employers who have very high turnover rates among their employees. This was one of the reasons why McDonald's abandoned its foray into autoenrollment a few years ago.[153] However, in its study, the DoL concluded that administrative costs attributable to complying with safe harbor requirements, such as providing QDIAs as part of the plan, amending the 401(k) plan, and providing additional notice related to QDIAs and autoenrollment would be minimal.[154]

3. *Lower Employer Contributions Provided for in New Safe Harbor*

Another feature of autoenrollment that could negatively impact some participants is that the new safe harbor offers less generous employer contributions than the old safe-harbor.[155] For example, a participant that contributes 6% of his or her compensation will receive an employer match of 3.5% of compensation under the new safe harbor rather than the 4% he or she would have received under the old safe harbor.[156] Similarly, the old safe harbor required full and immediate vesting

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152. *See* Laise, *supra* note 143, at A1 (noting that General Motors and FedEx have both recently suspended 401(k) matching contributions).

153. *See* Pender, *supra* note 88.

154. Default Investment Alternatives Under Participant Directed Individual Account Plans, 72 Fed. Reg. at 60,472.

155. *See* I.R.C. § 401(k)(12) (2006).

156. *Compare* I.R.C. § 401(k)(12)(B)(i) (traditional safe harbor provides that employer-matching contributions must be 100% of the first 3% of employee compensation that is electively contributed and 50% of employee compensation between 3% and 5% that is electively contributed) *with id.* § 401(k)(13)(D)(i)(I) (autoenrollment safe harbor provides that employer-matching contributions must be 100% of the first 1% of employee compensation that is automatically contributed and 50% of employee compensation between 1% and 6% that is automatically contributed). Thus, if a 401(k) plan participant contributes 6% of salary, the old safe harbor would provide an employer match of 4% while the autoenrollment safe harbor would provide a match of 3.5%.

of employer contributions whereas the autoenrollment safe harbor permits a vesting period of 2 years.[157]

The autoenrollment safe harbor was presumably set up with lower contributions and lesser vesting requirements in order to induce employers to switch over from the earlier safe harbor.[158] However, this switch may reduce the amount of savings for those employees who previously contributed to a safe harbor plan. Nonetheless, the amount of employees helped by being defaulted into the plan (i.e., receiving a 3.5% match rather than a 0% match) should more than make up for the employees who receive less employer contributions as a result of the new safe harbor provisions (i.e., receiving a 3.5% match rather than a 4% match).

H. *Other Factors that Stand in the Way of Autoenrollment Success*

1. *Early Withdrawals and Hardship Withdrawals*

Autoenrollment may be a step in the right direction, but Congress and the DoL may be overestimating the results that autoenrollment will achieve. One problem with autoenrollment that may lead to less retirement savings than anticipated is that once employees cease employment, they are permitted to withdraw their 401(k) account balance in full even if they are younger than retirement age (albeit with a 10% tax penalty).[159] Despite the 10% tax penalty, recent data reveals that a whopping 39% to 45% of participants in 401(k) plans chose to cash out their account balances when they changed jobs rather than rolling over their account balances to a subsequent employer's plan or an IRA.[160] In its calculation for the resulting

157. *Compare* I.R.C. § 401(k)(12)(E)(i) *with* I.R.C. § 401(k)(13)(D)(iii)(I).

158. *See* LANGBEIN, STABILE & WOLK, *supra* note 28 ("This new safe harbor is likely to be more attractive to employers than the traditional safe harbor.")

159. I.R.C. §§ 72(t)(2)(A)(i), 401(k)(2)(B)(i)(I).

160. *See* Default Investment Alternatives Under Participant Directed Individual Account Plans, 72 Fed. Reg. at 60,471 n.29 ("The proportion of those employees [in 401(k) plans] leaving with positive accounts that preserve their accounts for retirement [is] 61.0 percent."); MUNNELL & SUNDÉN, *supra* note 10, at 5 ("About 45 percent of participants in 2004 cashed out when they changed jobs."). *See also* Copeland, *supra* note 37 (36% of employees who take a distribution from their 401(k) plan when they terminate use at least some of the proceeds to pay off debts, mortgages or other loans; 17% use at least some of the proceeds for immediate consumption).

benefits from autoenrollment, the DoL actually assumed that 50% of those automatically enrolled will cash out when they change jobs.[161]

401(k) plans may also permit current employees to withdraw all or a portion of their accounts in times of financial hardship (as defined in Treasury Regulations) with similar tax consequences.[162] One prominent 401(k) provider revealed that it experienced a 17% increase in hardship withdrawals during 2007, partially attributable to employees' short-term needs of paying off mortgages and other debt.[163] If employees spend their 401(k) plan assets before they retire, the purpose of autoenrollment, not to mention the primary tax advantages of a 401(k) plan in and of itself is defeated.[164] If these trends continue or worsen, autoenrollment may simply be nothing more than a short-term tax deferred savings account rather than a means to provide savings toward retirement.

2. *401(k) Loans*

A similar problem occurs with regard to 401(k) plan loans. The vast majority of 401(k) plan sponsors permit employees to take loans from their 401(k) plans.[165] 401(k) loans

161. Default Investment Alternatives Under Participant Directed Individual Account Plans, at 60,471 n.29.

162. I.R.C. §§ 401(k)(2)(B)(i)(IV), 72(t); Treas. Reg. § 1.401(k)-1(d)(3) (2007) (allows for such a distribution only when "the distribution both is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the financial need."). *See* HEWITT ASSOCIATES, *supra* note 7, at 4 (94% of plans surveyed in 2007 allow for hardship withdrawals).

163. J.W. Elphinstone, *More Folks Tap 401(k)s to Pay Bills, Mortgages*, ST. LOUIS POST-DISPATCH, Feb. 20, 2008, at C1 (Fidelity experienced an increase in so-called hardship withdrawals of 17% during 2007 with a record number of withdrawals in December 2007). *But see id.* (Vanguard did not experience a notable increase in hardship withdrawals during 2007).

164. *Cf.* Copeland, *supra* note 37, at 9 ("By cashing out even small amounts, younger participants are sacrificing a potentially important asset for their retirement.").

165. *See* I.R.C. § 72(p)(2) (2000) (permitting DC plans to offer loans to participants, such that the loan distributions are not considered income subject to certain limitations, including a maximum loan of $50,000 or 50% of the account balance); HEWITT ASSOCIATES, *supra* note 7, at 4 (98% of 401(k) plans surveyed had a provision that allowed for loans from their plan); VanDerhei et al., *supra* note 58, at 1, 29 (18% of all 401(k) participants eligible for loans had a loan outstanding, amounting to 12% of their total account balances).

have increased dramatically recently as employees have recently been looking for alternative means to repay their mortgages or other debt.[166] If 401(k) loans are not repaid on time and enter default, then they are considered taxable income and are subject to the 10% tax penalty mentioned above.[167] In general, the repayment schedule for 401(k) loans is short (five years); however, if the loan is used to acquire a home, the permissible repayment schedule is longer.[168] With loans reducing plan assets for five years or more, there is a reduced timeframe for plan participants to save for retirement.

3. *Autoenrollment and QDIAs* Still *Might Not be Enough*

Even if participants choose not to take out loans, early withdrawals or hardship withdrawals from their 401(k) plans, the safe harbor autoenrollment provisions that default employees into 6% annual contributions may not be enough for participants to accumulate sufficient retirement benefits. According to one recent study by the ASPPA, if an employer adopts an autoenrollment safe harbor, an employee would have to contribute *10%* of salary per year from age 25 to age 65 in order to have an account balance at age 65 of 10 times final salary, the amount of funds expected to be necessary to last for life.[169]

166. *See* Elphinstone, *supra* note 163 (noting that one large 401(k) provider experienced a 13% increase in 401(k) loans during 2007); Eileen Ambrose, *Using 401(k) For Mortgage Payment Can Worsen Plight*, BALT. SUN, Nov. 11, 2007, at 1C (noting that T. Rowe Price experienced a 9% increase in loans during 2007); *see also id.* ("David Wray, president of the Profit Sharing/401(k) Council of America has no doubt that the uptick in loans is tied to the mortgage mess."); Tom Ramstack, *401(k) Debit Draws Red Flags*, WASH. TIMES, Feb. 18, 2008, at A01 (noting concern on the part of financial planners that people are enrolling in a debit card that takes out 401(k) loans in response to the economic downturn).

167. I.R.C. §§ 72(p)(1), 72(t)(1).

168. I.R.C. § 72(p)(2)(B)(i)-(ii).

169. Turpin & White, *supra* note 27, at 2. *See also* Jack VanDerhei & Craig Copeland, *The Impact of PPA on Retirement Savings for 401(k) Participants*, 318 EBRI ISSUE BRIEF 1 (2008), *available at* http://www.ebri.org/pdf/briefspdf/EBRI_IB_06-20087.pdf ("[E]ven with the large increases that can be expected for many workers under the safe harbor auto-enrollment plans introduced by PPA, and with current-law Social Security benefits, additional resources will still be needed for some.").

I. *Summary*

Despite some drawbacks and concerns, autoenrollment is a beneficial feature for 401(k) plans because it increases plan participation and, with the usage of QDIA defaults, will improve participant investment performance.[170] A DoL estimate (completed prior to the recent recession) found that over the next 25 years, the autoenrollment and QDIA provisions will lead aggregate 401(k) account balances to grow by between 2.8 and 5.4%, or between $70 billion and $134 billion.[171] A recent study by the Employee Benefit Research Institute found that autoenrollment provisions will result in 401(k) accumulations for low-income workers to jump from 0.1 times age 65 earnings to between 2.5 and 4.5 times age 65 earnings.[172]

Although the 401(k) plan model is disadvantageous to many employees compared to the DB plan model because employees must bear investment risk themselves, the PPA and DoL regulations encourage employers to default their employees into diversified investments that better approximate DB plan returns. Thus, autoenrollment should greatly lessen two of the primary negative aspects of 401(k) plans, poor plan participation and poor investment performance.

IV.
EMPLOYER-PROVIDED ANNUITIZATION

A. *Overview*

Another DB-like feature that employers should consider adopting as part of their 401(k) plans is an annuity form of payment. An employer-provided annuity option offered in a 401(k) plan would help to ensure that employees will be able to extend their retirement savings throughout their lifetime

170. *See* Pender, *supra* note 88, at D1, (quoting Harvard public policy professor as saying "[Autoenrollment] doesn't solve all the problems, but . . . it's a very positive step in the right direction.").

171. *See* Default Investment Alternatives Under Participant Directed Individual Account Plans, 72 Fed. Reg. 60,452, 60,466 (Oct. 24, 2007) (to be codified at 29 C.F.R. pt. 2550).

172. *See* VanDerhei & Copeland, *supra* note 169, at 1, 5.

once they retire.[173] Unfortunately, relatively few 401(k) plan sponsors offer annuities as part of their 401(k) plans.[174]

B. *Lack of Implementation to Date*

1. *Employee Preference to Rollover Account Balance and/or Receive a Lump Sum*

One major reason why 401(k) plan sponsors generally have not offered annuities is employee preference. When given the option, retirees on the whole prefer to collect their retirement benefits in the form of a single sum rather than as a stream of payments.[175] However, when a 401(k) plan does not offer an annuity form of payment at all, retirees are forced to assume their own longevity risk.[176] Of course, these employees have the opportunity to pay for an annuity on the open

173. *See* Zelinsky, *supra* note 3, at 462 ("With . . . a lifetime annuity it is by definition impossible for the retiree to outlive her pension income . . .").

174. *See* HEWITT ASSOCIATES, *supra* note 7, at 4 (15% of employers surveyed in 2007 offer annuities as an optional forms of payment for final distribution); Martha M. Hamilton, *Stretching the Limits of 401(k)s*, WASH. POST., Aug. 5, 2007, at F01 (noting that less than 50 companies have adopted annuity funds as an investment option within their 401(k) plans).

175. *See* Selection of Annuity Providers for Individual Account Plans, 72 Fed. Reg. 52,021, 52,023 n.4 (Sept. 12, 2007) (to be codified at 29 C.F.R. pt. 2550) (citing 2005 Hewitt Associates study showed that of employers that offer annuities as forms of payment from their 401(k) plans, only 6% of participants actually elect an annuity option at retirement); Munnell et al., *The Impact of Defined Contribution Plans on Bequests*, *in* DEATH AND DOLLARS: THE ROLE OF GIFTS AND BEQUESTS IN AMERICA 265, 271-72 (Munnell & Sundén ed., 2003) (citing empirical studies in which employees tended to select lump sums over annuities in instances when it would not be economically rationale to do so); ZELINSKY, *supra* note 42, at 22 ("Today, virtually all [DC] plans pay participants' account balances as lump sums, rather than as annuities."); Gary R. Mottla & Stephan P. Utkus, *Lump Sum or Annuity? An Analysis of Choice in DB Pension Payouts*, 30 VANGUARD CTR. FOR RET. RESEARCH 7 (Nov. 2007), *available at* https://institutional.vanguard.com/iam/pdf/CRRLSA.pdf (finding in a study of a DB plan that offered both lump sums and annuities that married participants elected a lump sum 75% of the time, even though such an election required additional administrative steps on the part of participants); SABLEHAUS, BOGDAN & HOLDEN, *supra* note 41, at 7 (finding that 18% of DC plan participants annuitized their entire account balance at retirement).

176. *See generally* Introduction, *supra*.

market using their retirement proceeds, but nonetheless, "rates of voluntary annuitization remain extremely low."[177]

2. *Qualified Joint & Survivor Annuity Requirements*

Another reason why employers have been reluctant to provide an annuity form of payment as part of their 401(k) plans is that ERISA requires that all DB plans and DC plans that offer annuities provide a default payment option known as a "qualified joint and survivor annuity" (QJSA).[178] The QJSA was introduced as part of the Retirement Equity Act of 1984[179] as an attempt to improve the retirement security of nonworking spouses, some of whom were left destitute when their spouses died.[180] The QJSA is the default form of payment for married participants under all DB plans and some DC plans; it consists of a monthly annuity payable to a retiree for life, with a survivor annuity continuing to a surviving spouse of between 50% and 100% of the retiree's annuity amount.[181] ERISA imposes several requirements upon a plan sponsor inherent with the QJSA, including a waiver that a spouse must sign in order for a retiree to collect benefits in any other form of payment and a written explanation of the QJSA and the

177. ANTHONY WEBB, GUAN GONG, & WEI SUN, CTR. FOR RET. RESEARCH AT BOSTON COLL., AN ANNUITY THAT PEOPLE MIGHT ACTUALLY BUY 1 (July 2007), http://crr.bc.edu/images/stories/Briefs/ib_7-10.pdf.

178. *See* ERISA § 205(a)-(b), 29 U.S.C. § 1055(a)-(b) (2006); I.R.C. § 401(a)(11)(A)-(B) (2006). For a 401(k) plan to avoid the QJSA requirement, it must pay a participant's accrued benefit in full to a surviving spouse in the event of death and not pay benefits to a participant in the form of a life annuity (broadly defined). *See* ERISA § 205(b)(1)(C)(i)-(ii), 29 U.S.C. § 1055(b)(1)(C)(i)-(ii); I.R.C. § 401(a)(11)(B)(iii)(I)-(II); Treas. Reg. § 1.401(a)-(11)(b)(1) (2006).

179. Retirement Equity Act of 1984, Pub. L. No. 98-397 (1984).

180. *See Pension Equity for Women: Hearings before the Subcomm. on Labor Mgmt. Relations of the House Comm. on Education and Labor, 98th Cong.* 26 (1983) (statement of Rep. Ferraro) ("Women are shortchanged by private pension plans . . . [The female homemaker] is dependent on her husband and his earnings and at the mercy of death or divorce."); Camilla E. Watson, *Broken Promises Revisited: The Window of Vulnerability for Surviving Spouses Under ERISA*, 76 IOWA L. REV. 431, 472-87 (1991) (discussing the process leading to Congress's decision to include the QJSA provision in the Retirement Equity Act of 1984).

181. ERISA §§ 205(a)(1), (d); 29 U.S.C. §§ 1055(a)(1), (d); I.R.C. § 401(a)(11)(A).

election procedures.[182] Because the QJSA creates additional administrative costs, 401(k) plan sponsors are understandably reluctant to offer an annuity form of payment that will force them to comply with those requirements.[183]

3. *Requirement of DC Plans to Provide the "Safest Annuity Available"*

Another reason why 401(k) plan sponsors have generally not provided an annuity form of payment is that a 1995 DoL Bulletin and a 2002 DoL Advisory Opinion provided that DC plans that offer annuities must choose the "safest annuity available" when selecting an annuity provider.[184] The Bulletin and Advisory Opinion announced that DC plans would be subject to fiduciary duties required by ERISA during the selection process of annuity providers and provided a 6-factor test that plan sponsors must adhere to when selecting an annuity provider.[185] Rather than engage in a costly search for an annuity provider and risk eventual fiduciary liability in the event that the annuity provider turned out to not meet the "safest available" standard, most employers have taken the safe route by not including an annuity form of payment in their 401(k) plans.[186]

182. ERISA § 205(c)(2)(A)(i), (c)(3)(A); 29 U.S.C. § 1055(c)(2)(A)(i), (c)(3)(A).

183. *See* PRUDENTIAL FINANCIAL, SURVIVOR BENEFIT RULES FOR DEFINED CONTRIBUTION PLANS 2 (2004) ("Some [401(k) plans] . . . are designed so that QJSA notices and consent are never needed."), http://www.prudential.com/media/managed/cpa9908.pdf.

184. Interpretive Bulletin Relating to the Fiduciary Standards Under ERISA When Selecting an Annuity Provider for a Defined Benefit Plan, 29 C.F.R. § 2509.95-1(c) (2007). A 2002 DoL advisory opinion confirmed that this section also applied to DC plans, despite the fact that the named federal regulation refers to DB plans. *See* 2002 Dept. of Labor Advisory Opinion 14A (2002), http://www.dol.gov/ebsa/regs/aos/ao2002-14a.html.

185. *See* 29 C.F.R. § 2509.95-1(c)(1)-(6); 2002 Dept. of Labor Advisory Opinion 14A, *supra* note 176; ERISA § 404(a)(1), U.S.C. § 1104(a)(1) (2006) (providing fiduciary duties for plan sponsors).

186. *See* Hamilton, *supra* note 174; HEWITT ASSOCIATES, *supra* note 7; Jessica Marquez, *IBM Strives for the Security of Defined-Benefit Programs as it Shifts to 401(k)s; Managed Accounts, Automated Features and Annuities are Aimed at Ensuring that Employees Have Enough to Last After Retirement*, WORKFORCE MGMT., June 1, 2005, at 79 (one expert noted in 2005 that the "fiduciary liabilities involved with offering annuities are a major reason that 401(k) plan providers have backed away from these options").

C. *Recent Developments in Annuity Offerings for 401(k) Plans*

1. *PPA and Proposed DoL Regulations Replace "Safest Annuity Available" Standard for DC Plans*

In response to employers' aversion to providing annuity coverage in 401(k) plans, the PPA announced that the 1995 DoL Bulletin does not apply to DC plans any longer.[187] The PPA provided that the DoL would have one year to issue final regulations that would permit DC plans to seek out annuity providers without being subject to the "safest available" restriction.[188] In proposed regulations issued in 2007, the DoL responded to the PPA's edict.[189]

The DoL's proposed regulations provide for a safe harbor that would allow an employer to satisfy its fiduciary duties while selecting an annuity provider.[190] In order to qualify for the safe harbor, an employer must:

> 1) Engage in an objective, thorough and analytical search for an annuity provider;
> 2) Employ an independent expert to evaluate whether an annuity provider is appropriate, if the employer lacks the expertise to decide on its own;
> 3) Assess whether the annuity provider has the ability to make future payments under the contract, taking into account the annuity provider's level of capital, surplus and reserves;
> 4) Assess the costs against the benefits to be obtained by the annuity provider, taking into account the annuity provider's experience and expertise; and
> 5) Periodically review the annuity provider with regard to its ability to pay future payments and in weighing costs and benefits of its service.[191]

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187. *See* Pension Protection Act of 2006 § 625(a)(1).

188. Pension Protection Act of 2006 § 625(a).

189. *See* Selection of Annuity Providers for Individual Account Plans, 72 Fed. Reg. 52,021, 52,021-25 (Sept. 12, 2007) (to be codified at 29 C.F.R. § 2550.404a-4).

190. *See* ERISA § 404(c)(1)(A); 29 U.S.C. § 1104(c)(1)(A) (2006) (providing fiduciary duties for individual account plans); 29 C.F.R. § 2550 (2007) (providing fiduciary duties for plan sponsors).

191. Selection of Annuity Providers for Individual Account Plans, 72 Fed. Reg. at 52,022.

Although the DoL forces employers to perform due diligence when selecting an annuity provider, this safe harbor appears to be more amenable to employers than the "safest available" standard, which had implied a more heightened standard of due diligence during the selection process. The DoL projects that once this regulation is finalized, there will be a modest increase in the number of plans offering annuities, with a total annual increase of $93 million invested in annuities by 401(k) plan participants annually.[192]

2. *Annuity Funds Offered in 401(k) Plans*

Another recent development with regard to annuity offerings is that insurers, financial institutions and other annuity providers have begun to develop annuity funds specifically designed for 401(k) plans.[193] These products enable employees to invest in funds that will pay out annuities upon retirement. These annuity funds are available at a cheaper cost than annuities would cost on the open market.[194] Also, because they are funds offered within the 401(k) plan, and not a form of payment offered by the plan, an employer does not have to comply with the QJSA requirements. Thus, an employer's fiduciary duties with regard to annuity funds are limited to reasonable monitoring, similar to the standard required for monitoring QDIAs discussed earlier.[195]

One criticism that some financial experts have made regarding these annuity funds is that there is no inherent tax advantage in investing in an annuity within a 401(k) plan.[196]

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192. Selection of Annuity Providers for Individual Account Plans, 72 Fed. Reg. at 52,023.

193. *See* Janet Kidd Stewart, *Annuities New Option for 401(k) Savings Plans*, CHI. TRIB., Aug. 26, 2007, at C7; Sandra Block, *Handful of Companies Offer Annuity Income from 401(k) Contributions*, USA TODAY, Sept. 11, 2007, at 3B; Eileen Ambrose, *Investor Can Leave Decisions to Funds*, BALT. SUN, Oct. 14, 2007, at 1C.

194. *See* Ambrose, *supra* note 193 (noting that the Fidelity 401(k) annuity fund offers an annual fee between .54 and .65 percent of invested assets while MetLife charges .70 to 1.00 percent, both cheaper than fees for an annuity purchased on the open market).

195. *See* 29 C.F.R. § 2550.404c-5(b)(2) (2008).

196. *See The DoL is Looking at Boosting 401(k)s with Group Annuity Features. Is This a Good Way to Increase Participation?*, DEFINED CONTRIBUTION NEWS, June 13, 2005, at 12 ("One of the biggest draws to annuity products is the tax advantage, but inside a 401(k) plan that doesn't matter.").

While this is true, there would appear to be an inherent benefit in making annuities available to participants who might not otherwise consider them, even if that investment has no direct tax advantage. This is particularly true for lower-paid individuals who would rely on annuities to fund their living expenses in retirement, rather than utilize them as a tax shelter.

Another criticism of these funds is that they offer lower returns than other diversified funds, such as a QDIA.[197] Nonetheless, it is unclear at this time which is a more sensible financial approach on the part of plan participants—investing in a life-cycle fund and then going on the market to purchase an annuity with a risk premium built in or investing in an annuity fund that is priced at a group rate.

Another criticism of these funds is that they may not be portable. If an employee switches jobs to an employer that does not offer a 401(k) annuity fund, the employee may be forced to liquidate his or her annuity fund and reinvest those assets into another fund sponsored by the new employer.[198] Until issues such as these are resolved, there might be little expansion into this area. In fact, many of these funds were available since 2004 or 2005 but, as of mid-2007, less than 50 companies had adopted such funds as part of their plans.[199]

D. *Advantages in Providing Annuities*

Although employers have been reluctant to offer annuities as part of their 401(k) plans, there are some reasons why employers should be more open to the idea of offering them. Most importantly, annuities help to relieve employees of assuming their own longevity risk.[200]

A 401(k) plan that pays benefits in a single sum incentivizes some perverse behavior for new retirees: they can imme-

197. *See id.* ("It is incredibly hard to find an annuity with a good guaranteed annual rate").

198. *See* Ambrose, *supra* note 193 (notes that the 401(k) annuity provided by MetLife may need to be liquidated when an employee switches jobs).

199. *See* Hamilton, *supra* note 174.

200. ZELINSKY, *supra* note 42, at 15 ("One can characterize this risk . . . as the possibility that a retiree's improvidence in his initial years of retirement will diminish his resources for later. Less judgmentally, longevity risk can be understood as the possibility that a retiree will underestimate his life expectancy and will therefore overconsume in his early rears of retirement, thinking (erroneously) that he has fewer years to live than he in fact does.").

diately take vacations, make luxury purchases or pay off creditors without any structure in place to ensure that their retirement accumulations will be available to pay for regular expenses or necessities later in life. This problem will likely be compounded for lower-paid and lesser-educated employees compared to their higher-paid and more financially savvy counterparts. Since lower-paid employees are unlikely to have personal savings outside of their retirement plans, these employees may inevitably drain their 401(k) assets relatively quickly after retirement. Some of these employees may lack the financial wherewithal to determine how to properly invest a large sum; therefore, the unfortunate impulse for these individuals may be to spend on luxury goods or other unnecessary expenses, without realizing the long-term repercussions.[201]

Retirees could go on the open market and purchase an annuity from an insurance company on their own. However, employers would be able to get a much better group rate for annuities by bargaining with insurance companies compared to the rates that individuals could get independently on the open market.[202] Much of the reason that these employees could get better rates through their employer is because retirees who buy annuities on the open market are often healthier than the general population, so insurance companies must charge a premium in order to make a profit.[203] Furthermore, experience suggests that employees do not invest their 401(k) accumulations into annuities even in instances when it would make financial sense to do so.[204]

The costs involved for an employer in adding 401(k) annuity funds would be minimal, since an employer can spread the cost of the group rate across the 401(k) accounts of all

201. *See* MUNNELL & SUNDÉN, *supra* note 10, at 7 ("The real challenge will come as those dependent on 401(k) plans arrive at retirement and have to figure out how to allocate their 401(k) balances over their remaining lifetime.").

202. *See* Munnell et al., *supra* note 175, at 274 (noting that one reason why "the market for annuities in the United States is miniscule" is that the risk premiums that insurance companies are demanding are too high); ZELINSKY, *supra* note 42, at 16.

203. *Id.*

204. *Cf.* Munnell et al., *supra* note 175, at 270-71 n.6 (citing a 2000 study that revealed that less than half of households expect to annuitize at least some portion of their DC accounts).

plan participants. However, with 401(k) plan sponsors coming under additional scrutiny for excess fees associated with their plans, there might be understandable reluctance on the part of employers to implement a new plan feature that would spread administrative costs to all plan participants.

Another advantage to annuitization is that, in the case of improper spending or budgeting on the part of a retiree, an annuity form of payment can protect the welfare of surviving spouses or partners. ERISA provides that the QJSA is the default form of payment in DB plans in order to ensure that surviving beneficiaries will not be left destitute if they are predeceased by retirees.[205] By providing a lump sum payment upon retirement, 401(k) plans are not structured to ensure the welfare of surviving spouses in the way that DB plans are. In fairness, two-income earner households have increased dramatically since the QJSA requirements were introduced in 1984, so perhaps spousal protection should no longer be a top priority for retirement plans. Also, *so long as the retiree properly budgets and/or invests his or her lump sum*, surviving spouses and children may be at an advantage under the 401(k) structure compared to a DB plan because they stand to inherit any remaining account balance accumulated at the time of the retiree's death (after taxes are taken into account).[206] Nonetheless, the single sum payment structure has a major drawback in that it allows for the possibility that retirees will drain their savings before death, thereby leaving widows or widowers or other beneficiaries with no remainder.[207] This problem is exacerbated if a widow or widower outlives a retiree for an extended period of time.

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205. ERISA § 205(a), 29 U.S.C. § 1055(a) (2006).

206. A DB plan provides for a survivor annuity to continue to a spouse upon a retiree's death only when a QJSA or other survivor annuity is affirmatively elected. If a married employee dies while in active employment entitled to a vested benefit, a qualified preretirement survivor annuity (QPSA) must be paid to a surviving spouse. ERISA § 205(a)(2), 29 U.S.C. § 1055(a)(2). ERISA does not require DB plans to provide for any survivor benefits for children. ERISA § 205(a), 29 U.S.C. § 1055(a).

207. *Cf.* Munnell et al., *supra* note 175, at 274-75 (noting that when spouses pool their assets and name each other as their prime beneficiary in the event of death, they are able to hedge somewhat against the risk of exhausting their finances, but empirical evidence suggests that such an approach yields only 46% of the protection offered through annuities).

E. *Installment Payments – An Alternative to Annuities*

Another alternative that employers can offer to employees is installment payments. According to a recent survey, about 50% of employers offer installment payments as a payment option as part of their plans.[208] Another study, however, found that only 6% of all DC plan participants receive their benefits in the form of installment payments upon retirement.[209]

If an employee elects to be paid via installment payments, the employee would receive his or her account balance in installments, beginning at retirement, with payments for each of the following ten years, for example. Installment payments solve part of the problem since they force retirees to budget their retirement savings. However, installment payments are still an imperfect solution because employees still run the risk of outliving the installment payment period. An annuity form of payment is thus the only way to remove the burden of longevity risk from the employee.

F. *Summary*

Annuitization would thus be a beneficial feature for 401(k) plans because it would minimize improper spending incentives for retirees and reassign longevity risk toward annuity providers and away from individual employees.

With both Social Security and Medicare facing an uncertain future, the coming generations of retirees, especially lower-paid retirees, may find themselves in severe financial trouble if their 401(k) balances dry up when they are elderly and unable to return to the workforce. If that future awaits, employers may then face a human relations or public relations nightmare if their former long-time workers are left destitute. Retirees who drain their 401(k) benefits who are unable to work might then have to turn to their children or other family members for financial support. Conceivably, the single-sum retirement payment system, if mismanaged by retirees, could lead to the eventuality of a taxpayer bailout of Social Security and/or Medicare down the road.[210]

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208. Kathy Chu, *Caring for Your Nest Egg*, U.S.A. TODAY, Nov. 9, 2005, at 09B (citing a Hewitt Associates 2005 survey that revealed that about one-half of 401(k) plans surveyed provide an installment payment option).

209. *See* SABLEHAUS, BOGDAN & HOLDEN, *supra* note 41, at 7.

210. *Cf.* Copeland, *supra* note 57.

Thus, annuitization is another DB feature that employers should implement as part of their 401(k) plans.

CONCLUSION

The retirement landscape has seen a dramatic shift over the last 25 years from DB plans to DC plans. Despite this shift, DB plans offer many beneficial features that improve retirement savings which DC plans do not.[211] Thus, employers should consider modifying their 401(k) plans by incorporating some of these features and protections via autoenrollment and annuitization.

DB plans are advantageous to employees because they can avoid investment risk and longevity risk, which are borne by their employers instead. Annuitization would enable employees to divert longevity risk to an annuity provider within the format of a DC plan. Autoenrollment does not necessarily minimize investment risk for employees; in some cases, it may add to investment risk because it may push employees into riskier funds than they otherwise would have been invested in. But autoenrollment is advantageous to employees because they will default into QDIAs that are relatively comparable to diversified DB plan portfolios. Even though investment risk may be increased somewhat via QDIAs, autoenrollment enables more employees to acquire sufficient retirement savings, thereby validating the DC format of retirement savings for rank-and-file employees. More importantly, autoenrollment brings employees into plans in the first place—401(k) plans will not improve retiree welfare if participation is limited. Autoenrollment brings 401(k) plans far closer to the DB mandatory participation standard than the optional enrollment format that had previously been the 401(k) standard.

Autoenrollment and annuitization will help to improve retirement benefits and security, but even more DB-like features and concepts can be adopted in order for retirement savings to be maximized. Employers should consider offering nonelective contributions rather than matching contributions

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211. *See* Phyllis Feinberg, *Annuities, Automatic Enrollment Part of DC's New Look: Plans are Starting to Look More Like Defined Benefit Kind*, INVESTMENT NEWS, May 16, 2005, at 22 ("[P]lan sponsors who have, or once had, [DB] plans are figuring out how to take some of the best features of DB plans and use them to create better DC plans.").

(or no employer contributions) in their 401(k) plans. More efforts should be made to discourage employees from early withdrawals or loans absent absolute necessity.[212] As Professor Edward Zelinsky recommends, the 10% limit of company stock investment that applies to DB plans should be extended to DC plans.[213] Given the recent sharp decline in financial markets, it might be time to recognize that more radical initiatives will be necessary in order to properly shore up investment risk in DC plans.

Perhaps further initiatives along these lines should be examined the next time Congress deliberates about improving retirement security. But as the law of retirement stands today, autoenrollment and annuitization are tools that employers should consider implementing in order to provide their employees DB-like benefits, features and retirement security as part of their 401(k) plans.

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212. *See* Estreicher & Gold, *supra* note 12, at 339 ("A stringent rule limiting 401(k) or other DC plan distributions for workers aged 59.5 or less to a roll-over to another 401(k) or to an IRA is essential to assuring that 401(k) plans fulfill their assigned tax-supported role as *pension* plans.").

213. *See* ZELINSKY, *supra* note 42, at 160-61 ("It is . . . anomalous that the ten percent limit on employer stock does not apply to [DC] plans.").