Stock-Drop Litigation, Professional Liability Insurance, and the Pension Protection Act of 2006

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Abstract

Over the last decade, 401(k) plans have become the dominant source of employer-sponsored retirement funds for U.S. workers. Due to the volume of company stock held in 401(k) plans and the poor economic environment of the early 2000's, plan participants began to bring legal action against plan sponsors leading to significant settlements, some of which were covered by professional liability policies. In August of 2006, the Pension Protection Act of 2006 was passed and many believed it could potentially reduce the likelihood of stock-drop litigation or at the very least reduce the liability exposure of plan sponsors. This paper reviews the events leading up to the passage of the Act and evaluates the potential impact of the Act on stock-drop litigation and professional liability insurance.

Introduction

From 1991 to 2000, the United States experienced the longest peace-time economic expansion in its history.[1] Partly as a result of the economic success of the time, employer-sponsored 401(k) retirement plans saw an increase in the number of employers offering such plans and the frequency of company stock used both as a matching instrument and an investment option. By 2000, approximately 72 percent of large firms (those with 5,000 participants or more) provided company stock as an investment option to plan participants (Profit Sharing Contribution/401(k) Council of America, 2001).

In March 2001, the U.S. economy entered a period of economic decline that resulted in a large number of firms experiencing significantly decreased equity value. As the market decline negatively impacted those invested in these firms, great attention became focused on the losses of companies with defined contribution (DC) plans which held large amounts of the employers' stock. In addition to the adverse effects of the weak market, a number of firms were entrenched in fraud and scandals which led to the failure of some of the nation's biggest companies, including Enron, Lucent, and WorldCom.

Of the aforementioned firms, the most notable of these cases involved Enron Corporation. With over 11,000 employees participating in Enron's 401(k) plan, the company matched employee contributions in the form of Enron stock, which partially led to 62 percent of the 401(k) plan assets being invested solely in Enron stock (Benartzi, Thaler, Utkus, and Sunstein, 2007). In addition, employees were not permitted to

[1] During this time, the Dow Jones Industrial Average and S&P 500 reached record closing levels of 11,750.28 and 1,500.64, respectively.

diversify their company stock holdings until they met long-term age and service requirements. Over a little more than one year, plan participants watched as Enron's stock plummeted from an all-time high of $90 per share in August 2000 to a low of $.26 per share in November 2001 which ultimately led to the bankruptcy of the firm. The resulting class action lawsuit proved to be what many consider the beginning of a bevy of stock-drop cases and tag-along securities lawsuits, in which plan participants would bring legal action against their employers following a drop in stock price as a result of fiduciary negligence while owners of the plan sponsor's equity would also pursue legal action against the directors and officers for the stock's decline in value.[2] The Enron case ended (in-part) with an $85 million settlement, paid by Enron's insurers.[3]

Not long after the bankruptcy of Enron, WorldCom filed for bankruptcy on July 21, 2002, resulting in a lawsuit brought forth by WorldCom 401(k) participants who had invested heavily in WorldCom company stock.[4] The suit ended with a $55 million settlement in November of 2005 with the insurer paying $50 million of the settlement. This was followed by additional stock-drop suits involving well-known firms such as Kmart (2003), Lucent Technologies (2003), Sprint (2004), CIGNA (2005), Krispy Kreme (2006), and most recently General Motors (2008). In part as a response to public demands, Congress passed the Pension Protection Act of 2006 (PPA 2006) which

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[2] A tag-along claim occurs when 401(k) plan participants bring legal action against the plan sponsor and fiduciaries by modifying an existing shareholder class action lawsuit to address similar violations under ERISA (MacLeod, 2007). According to Sharma (2007), tag-along suits are often brought about because limitations and requirements associated with lawsuits under federal securities law are not applicable to ERISA actions for fiduciary duty.

[3] Associated Electric & Gas Insurance Services, Ltd. (AEGIS) issued Enron its primary liability insurance policy (a fiduciary and employee benefits liability insurance policy) with an aggregate limit of $35 million. Federal Insurance Company issued Enron an excess fiduciary policy with an aggregate limit of $50 million in excess of the primary policy's $35 million limit [*Tittle v. Enron Corp., No. 05-20380 (Court of Appeals 5th Circuit)]*.

[4] The WorldCom bankruptcy was the largest Chapter 11 bankruptcy filed in U.S. history.

included a number of restrictions and requirements affecting the design and management of employer-sponsored plans.

In this paper, we evaluate the potential impact of the PPA 2006 on stock-drop litigation and professional liability insurance. More specifically, we first provide some background information on: (1) the role of company stock in DC plans; (2) the laws that regulate these plans and the fiduciaries who manage the plans; and (3) the use of professional liability insurance in managing associated fiduciary liability. We then discuss the PPA 2006 and the sections most relevant to stock-drop litigation. Next, we evaluate the potential impact of the PPA 2006 by examining trends in vesting and divestiture requirements among plan sponsors and the use of company stock in DC plans. We conclude with a discussion of future potential issues facing fiduciaries with respect to employer-sponsored retirement plans and the effects on liability insurance.

Background

The Role of Company Stock in Defined Contribution Plans

In a DC plan, typically the employer and/or the employee makes contributions to the participant's retirement account whereby the participant may direct the use of the funds for the benefit of retirement savings. Usually, these plans offer the employee an assortment of investment options and at the time of retirement, the employee gains access to the accumulated benefits from the retirement plan.[5] With DC plans, the investment risk is borne entirely by the participant. As such, poor investments could lead to a significant shortfall of funds necessary for retirement. Sponsors and fiduciaries may find

[5] Typically, investment options are in the form of mutual funds and consist of stock funds, bond funds, and money market funds.

themselves subject to stock-drop litigation in cases in which the employee selects company stock or the stock is provided on a matching basis.

As noted above, one of the investment options commonly available to employees is company stock. It can be argued that both the sponsor and participants gain some benefits from having company stock as an investment option. For example, management often cites desired increases in employee motivation and productivity as a reason for the inclusion of company stock in a DC plan. While such a result may be intended, the majority of academic studies have shown that increases in productivity are either negligible or non-existent.[6] Another reason employers match with company stock or offer company stock as an investment alternative within a DC plan is to reduce organizational costs. By including company stock within a plan, the sponsor is able to reduce costs as the administrative costs associated with company stock are minimal and significantly less than those costs associated with the inclusion of other investment options (Brown, Liang, and Weisbenner, 2006).[7] For example, if the shares are new issues or if they come from the company's treasury, the company does not experience a decrease in cash flows (Purcell, 2002). Although cost savings may be desirable, the realization of cost advantages is based in large part on the method in which the firm acquires the company stock. For instance, if the firm opts to purchase the stocks directly from the market, the firm should not experience any cost savings.[8]

[6] See U.S. General Accounting Office (1986) and Kruse and Blasi (1995) for an in-depth discussion on the potential productivity and motivation benefits of employee company stock ownership.
[7] In 2006, Rauh stated that if the firm is facing financial constraints and feels the employees will value the company stock more than the market, then providing the stock to the employees is much more cost effective than matching employee contributions with cash.
[8] In 2001, Benartzi estimated that approximately 33 percent of firms purchased company stock on the open market, indicating that a large portion of firms may not be gaining cost savings through the use of company stock in their DC plans.

A final commonly cited reason for providing company stock to plan participants in a DC plan is to attempt to ensure control of the organization by keeping stock in the "friendly hands" of employees. The "friendly hands" theory states that by offering company stock as an investment option and/or matching employee contributions with company stock, the firm may reduce the risk of a takeover (Benartzi, Thaler, Utkus, and Sunstein, 2007).[9] More specifically, employee ownership of company stock can reduce the likelihood of hostile takeovers as current management uses the employees as allies against such takeovers.[10]

The benefits anticipated by employees are most likely not the same as those experienced by the employer. It is hypothesized that the employees can maximize the amount of money available at the time of retirement by contributing the maximum allowable amount and by selecting investments that will result in the highest return.[11] In order to maximize investment returns, it has been argued that plan participants may increase their investment in company stock as the Modern Portfolio Theory contends that in order for rational investors to take on increased risk (such as that associated with a single stock) the investors will require an increased return (Markowitz, 1952). In 2002, VanDerhei provided an analysis of the impact of company stock matching within 401(k) plans and the potential impact of removing the option of company stock matching from employer-sponsored plans. The author found that if employees are able to have complete

[9] Rauh (2006) finds that firms do use company stock as a method of reducing the likelihood of hostile takeovers. As laws are put in place which insulate management from the possibility of a hostile takeover, the author found a reduction in employee ownership of company stock. Similarly, Pagano and Volpin (2006) also find that employees can act as deterrents to hostile takeovers.

[10] In addition to reducing the likelihood of hostile takeovers, the idea has also been presented that increasing the amount of company stock in plan participant hands can ease the impact of negative news on equity price if the sponsor restricts divestiture of company stock.

[11] The primary value of utilizing a qualified employer-sponsored DC plan for employees is that the contributions can be made on a tax-deferred basis and the employer contributes to the plan as well. For 2008, the maximum allowable employee elective deferral to a 401(k) plan is $15,500 per year.

control over the selection of the assets held within their retirement plan portfolios, their allocations would have lower concentrations of equity and yield lower expected rates of return, indicating that company stock does play an important role within a 401(k) plan.[12]

Related to the issue of investment returns is the issue of investment risk and diversification. By employing different types of investments within a retirement portfolio from varying industries, investment strategies, and geographies, the investor should be able to reduce the amount of idiosyncratic risk that is assumed. Thus, by including a single firm's stock in the retirement portfolio, the risk may become further diversified. However, as has been noted in previous research, DC plan participants do not always diversify and may even concentrate the majority of their portfolio in the employers stock. While this may allow the investor to gain exceptional returns in the event of strong firm performance, the lack of diversification could increase the possibility that the participant's DC plan account is not sufficient at the time of retirement.[13] In addition to return and diversification benefits, some posit that employees may also gain non-monetary benefits, such as feeling like a member of a team. However, there is very little empirical evidence to indicate that such a benefit exists or should be used for purposes of utilizing employer stock. In 2007, Benartzi et al. performed a survey study in which he found that while 32 percent of those surveyed felt that company stock ownership made them feel better, 59 percent felt that company stock ownership either had no effect on them or made them less happy.

[12] VanDerhei found that accounts with company stock would have expected average balances with four to 7.8 percent larger returns than those without company stock.

[13] Mitchell and Utkus (2002) expressed that one reason why employees may overload portfolios with employer stock is because they may believe that the risk associated with their employer's stock is less than the risk associated with other stock. Benartzi (2001) found that employee investment in company stock increases when the firm matches in company stock rather than cash, with 18 percent of participants investing their own contributions in company stock with cash matching and 29 percent of participants investing their own contributions in company stock with stock matching.

The Employee Retirement Income Security Act of 1974

The Employee Retirement Income Security Act of 1974 (ERISA) is a federal statute that was initially created in an effort to provide minimum standards for private employer-sponsored retirement plans while also providing pension plan federal tax policy. The two sections of ERISA relative to the current discussion are Sections 409 and 502(a)(2). Section 409 of ERISA establishes personal liability for any fiduciary that has breached a fiduciary duty, either by way of act or omission and Section 502(a)(2) of ERISA authorizes legal action by participants and beneficiaries of the plan as well as the Department of Labor for relief under Section 409. While these sections of ERISA create liability for breach of fiduciary duty, Section 404(c) provides some protection for fiduciaries. The guidelines contained in ERISA Section 404(c) and set forth by CRF Title 29 Section 2550.404(c)-1 allow plan sponsors to greatly reduce their exposure to liability by transferring investment decision-making responsibilities from the plan sponsor to the plan participants.[14] In order to be considered Section 404(c) compliant, a plan sponsor must meet a number of requirements. From a very superficial level, the basic requirements state that:

1) The plan must provide an opportunity for the participant to choose from a broad range of investment alternatives;
2) The plan must permit participants to exercise control over their assets whereby they may change their allocation of assets "with a frequency which is appropriate in light of the market volatility to which the investment alternative may reasonably be expected to be subject"; and

[14]As stated in a brief of the Secretary of Labor as amicus curiae opposing Enron's motion to dismiss in the case of *Tittle v. Enron Corp.*, "The only circumstances in which ERISA relieves the fiduciary of responsibility for a participant-directed investment is when the plan qualified as a 404(c) plan" [*Tittle v. Enron Corp.,* Civil Action No. H-01-2913 (S.D. Tex.)], retrieved from http://www.dol.gov/sol/media/briefs/enronbrief-8-30-02.pdf.

3) The plan must provide the participants with sufficient information which will allow participants to make informed investment decisions.

While these three requirements do focus on a number of the major themes of 404(c) (i.e. permitting participant-directed investment of plan assets), they are not the only requirements. Additionally, in order to gain the benefits of 404(c) compliance, a plan sponsor would need to "…provide proof of comprehensive adherence with the regulation in its entirety" (Witz, 2007).

Stock-drop litigation is usually brought forth under ERISA on the basis that: "(1) the firm knew that the inclusion of company stock as an investment option in the 401(k) plan was not prudent, (2) the firm failed to provide material information or provided misinformation which did not allow plan participants to properly assess the stock's value in their 401(k) portfolio, and/or (3) the employer breached its fiduciary duty to monitor appointed fiduciaries" (Chester, Dodds, and Walker, 2005). Often, plaintiffs allege that some combination of these failures took place which led to a loss in plan value. For example, in the case of *In re Honeywell ERISA Litigation*, the plaintiffs alleged that Honeywell breached their fiduciary duties by causing the plan to purchase and hold shares of company stock when they were aware that the stock was an "unsuitable and imprudent investment" for the 401(k) plan. The plaintiffs also alleged that the plan fiduciaries misrepresented the financial status of Honeywell and thus the actual value of the company's stock (Anonymous, 2005). In the case of *In re Allegheny Energy Securities Litigation*, plan participants argued that Allegheny Energy's common stock was not a prudent investment within the firm's 401(k) plan. Additional breaches alleged by the plaintiffs included their "…abdication of the continuing duty to review, evaluate, and monitor the suitability of the Plan's investment in Allegheny Stock and to provide

accurate material information to enable participants as would enable them to make informed investment decisions concerning their contributions invested in Company stock".[15]

Professional Liability Insurance

An ERISA stock-drop lawsuit can affect a number of individuals associated with an organization if they can be identified as ERISA fiduciaries. Because of the potential size of these lawsuits, even when cases are settled prior to going to trial, the cost of litigation can be significant with settlements in the range of millions of dollars (Sharma, 2007). For example, in 2005, Honeywell settled with plan participants for a total of $14 million in cash to be paid by Honeywell's insurer in the case of *In re Honeywell ERISA Litigation*. In 2007, Krispy Kreme Doughnuts settled its stock-drop suit for a total of $8.57 million, with $4.75 million paid in cash from their insurers in the case of *Smith v. Krispy Kreme Doughnut Corp.* Additional notable stock-drop lawsuits resulting in insurer payments are located in Table 1. One way to mitigate the negative monetary consequences of such legal action is by purchasing professional liability insurance. However, as discussed above and noted in the table below, even when liability insurance has been purchased, the available policy may not be sufficient to cover the entire loss.

One type of policy that is often used by organizations to deal with the potential for legal action is the directors and officers liability insurance (D&O) policy. D&O policies generally provide coverage for liability arising from the duties associated with corporate director and officer positions. Specifically, these policies typically cover directors and officers for losses and defense costs related to claims made against them as

[15] [*In re Allegheny Energy Securities Litigation*, Master File : 03-MD-1518 (D.C. MD)], retrieved from http://alleghenyenergyerisasettlement.com/files/complaint.pdf.

Table 1 – Recent Stock-Drop Settlements Paid Out by Insurers

Company	Settlement Date	Total Settlement (Millions)	Amount Paid By Insurer (Millions)	% Paid by Insurer
ADC	September 2006	$3.25	$3.25	100%
CMS Energy	June 2006	$28	$28	100%
Enron	May 2005 and April 2006	$137.7 (Multiple Lawsuits)	$122.5	88.96%
Global Crossing Ltd.	November 2004	$79	$54	68.35%
Harnischfeger Industries	June 2006	$10.85	$10.85	100%
HealthSouth Corp.	June 2006	$28.75	$18	62.60%
Honeywell	July 2005	$14	$14	100%
Krispy Kreme Doughnut Corp.	September 2006	$8.57	$4.75	55.42%
Royal Ahold N.V. Securities	July 2006	$2.5	$2.5	100%
Royal Dutch/Shell Transport	August 2005	$91	$25	27.47%
Williams Cos.	November 2005	$55	$50	90.90%
Total		**$458.62**	**$332.85**	**72.57%**

Note: Table adopted from Fiduciary Counselors June 15, 2007 ERISA Class Action Settlements and Attorney Fees Report

the result of their wrongful acts when the corporation cannot provide indemnification or is not permitted to do so. Additionally, such a policy may also provide coverage for the corporation if it must indemnify its directors and officers (Underwood, 2005).[16] However, while D&O policies may prove beneficial in the event of a tag-along lawsuit where the organization's investors bring securities-related legal action against the firm, these types of policies commonly include specific exclusions for ERISA-related liability. A more appropriate policy to deal with the ERISA fiduciary-related risks is the fiduciary liability insurance policy. Such a policy typically provides coverage for legal defense costs and potential losses resulting from ERISA litigation and may be used as a stand-alone policy or as an endorsement to an existing D&O or commercial general liability policy (Larsen, 2001).

[16] These coverages are classified as Side A and Side B coverages, respectively.

Because fiduciary liability insurance is considered a "non-standard" policy, there is no one way to describe its characteristics. However, in general these policies are designed to cover losses resulting from the wrongful acts of fiduciaries responsible for providing services to an employee benefit program. More specifically, these policies provide coverage for fiduciaries and the plan sponsor in the event of breaches of fiduciary duty and administrative errors. The policy can provide coverage for the plan itself, as well as past and present employees acting as fiduciaries, trustees, and plan employees (Moore, 2007). As noted by Clarke, "The best coverage will encompass any conceivable discretionary judgment action, and will not provide for a claims retroactive date" (Clarke, 2005). With regard to fiduciary liability limits, Clarke indicates that underwriters routinely make up to $15 million of individual insurer capacity available for smaller employers and up to $75 million to $100 million for larger employers, although the upper limits are rarely used.

In addition to fiduciary liability insurance, retirement plan fiduciaries can also be afforded liability protection via fidelity bonds and employee benefit liability insurance (EBLI). ERISA fidelity bonds are required by law and provide protection against dishonesty. Specifically, ERISA requires fiduciaries who handle plan funds to be bonded in an amount no less than 10 percent of the amount handled by the fiduciary and no greater than $1 million (Gilbert, Levin, and Downie, 2006).[17] When retirement plan funds are stolen, either via dishonesty or fraud, the funds may be recovered through the fidelity bond. In terms of EBLI, typically these policies provide coverage for claims regarding errors and omissions in the administration of a benefit plan that are not

[17] The PPA 2006 increased the maximum amount of fidelity bonds for plans holding employer stock from $500,000 to $1 million.

considered ERISA violations and are often used in conjunction with fiduciary liability policies.[18]

In the early 2000's, those involved in the professional liability industry were faced with a hard market, characterized by more stringent underwriting requirements, more restrictive coverage, and an increase in the number of insurers with negative loss ratios. In addition, the industry experienced a 29 percent increase in premiums, the largest increase since the mid 1980's (Tillinghast-Towers Perrin, 2002).[19] For example, in 2002 a firm looking to purchase a $25 million fiduciary liability policy with a retention of $100,000 to $500,000 would pay approximately $125,000 in premiums, whereas in 2004 a policy with significantly lower limits ($10 million) would cost the sponsor anywhere from $200,000 to $400,000 (Suszynski, 2004). However, as noted in a 2007 Frank Crystal and Company report, although significant premium volatility existed from 2000 to the second quarter of 2005, the market has softened greatly over the previous two years and plan sponsors have seen relatively flat or reduced premiums (with reductions of 10 to 15 percent), creating an environment in which plan sponsors may purchase needed coverage with greater ease (Willis, 2007).

Pension Protection Act of 2006

On August 17, 2006, the Pension Protection Act of 2006 was signed into law in an effort to encourage savings among the U.S. workforce while also protecting those

[18] Although some fiduciary liability insurance policies provide for EBLI coverage, they do not all provide these coverages.
[19] The hard market was attributed to a number of different factors, including an increased demand for coverage, an upsurge in the number of securities lawsuits, an increase in the cost of reinsurance following the terrorist attacks of September 11, and the decline of the stock market.

employees participating in employer-sponsored retirement plans. While much of Act focused on the shift from defined benefit (DB) to DC plans, the Act also dealt with fiduciary responsibility issues involving DC plans. Specifically, the Act: (1) requires employer-provided investment advice be provided to plan participants; (2) creates diversification/vesting requirements for those participants holding company stock; and (3) institutes notification requirements to employees regarding their rights. As of year-end 2006, over 50 million American employees were participating in 401(k) plans, containing $2.7 trillion in assets. As such, this legislation is expected to have far reaching consequences (VanDerhei, Holden, Copeland, and Alonso, 2007). Of the sections of the Act that target the holding of employer stock in an employer-sponsored retirement plan, Sections 901 and 507 are likely to have the greatest impact for both the employee and the employer.

Section 901 (Defined Contribution Plans Required to Provide Employees with Freedom to Invest Their Plan Assets) requires that participants be fully vested in employer contributions of employer stock in DC plans within three years of employment with the sponsor. This section amends Section 401(a) of the Internal Revenue Code of 1986 and requires that plan participants with sponsor-contributed company stock in their DC portfolios be permitted to divest their holdings and reinvest an equivalent amount in other investment options in order for the plan to maintain a qualified plan status.[20] A Hewitt Associates survey found that 34 percent of 401(k) plans that match participant contributions with company stock required participants to reach a certain age before they could divest out of the company stock investment (Purcell, 2002). This was the case with

[20] Qualified plan status permits the employer offering the retirement plan to receive a tax deduction for plan contributions while participants do not pay taxes on the assets accumulating in the plan until the assets are distributed.

Enron, where employees were not permitted to divest out of company stock until they reached the age of 50 (U.S. General Accounting Office, 2002). Similarly, in the case of *In re CIGNA Corp. ERISA Litigation*, plan participants were required to maintain the company matched stock in their account until the age of 55.[21]

Section 507 amends ERISA Section 101 and requires that plan sponsors inform participants of the right to divest company stock. Specifically, Section 507 (Notice of Freedom to Divest Employer Securities) requires that employers inform participants of the Section 901 divestiture requirement and provide the participants with information about the importance of diversification of retirement account assets no later than 30 days prior to the date on which the employee must be permitted to divest company stock.

Potential Impact of the Pension Protection Act of 2006

Vesting and Divestiture Requirements

The question of whether the PPA 2006 will provide long-term benefits to employers and employees as well as reduce the volume of unwarranted stock-drop lawsuits and lower the cost of related liability insurance products remains to be seen. To gain some insight into this issue, it is necessary to consider both the issues of the pre-PPA 2006 employer vesting requirements and the timing of stock-drop litigation. While the PPA 2006 requires plan sponsors to permit diversification of unwanted company stock, an evaluation of trends prior to the passage of the Act may provide some insight into the overall impact of the Act.

Prior to the passage of the PPA 2006, firms appeared to be aware of the potential liability inherent in offering employees a 401(k) plan and many employers were already

[21] As part of the CIGNA settlement, CIGNA agreed to amend the 401(k) plan to allow for diversification of matching.

reducing (if not eliminating) company stock vesting requirements. In 2001, a Hewitt Associates survey found that only 15 percent of companies allowed plan participants to immediately diversify company stock matching contributions (Sammer, 2006). By 2005, Hewitt Associates found that 24 percent of those companies surveyed allowed plan participants to immediately diversify company stock matching contributions. This would seem to indicate that even prior to the PPA 2006, firms were reducing company stock diversification restrictions for plan participants. However, as has been noted in a number of studies, even when given the opportunity, employees often do not divest their holdings of company stock or may not make optimal changes to their retirement accounts.[22]

With respect to the timing of the stock-drop lawsuits, one should note that while the PPA 2006 allows participants to diversify stock holdings after three years, workforce mobility may greatly reduce the benefits of this requirement. According to Coronado and Copeland, one of the primary reasons for the shift from DB to DC plans among employers is the changing demographics of the workforce (2004).[23] In 2007, VanDerhei found that as of year-end 2006, approximately 33 percent of all 401(k) participants in his study's sample had no greater than five years of tenure.[24] Assuming this trend is applicable to the population, this may indicate that a number of employees may not be sufficiently protected from holding unwanted employer-contributed stock in their 401(k)

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[22] See Choi, Laibson, Madrian and Metrick (2001); and Agnew, Balduzzi, and Sunden (2003) for more detailed information. Additionally, while evidence suggests participants may not make necessary changes (even when given the opportunity to do so), it is possible that this may change given the additional PPA 2006 sections addressing participant investment education.

[23] Specifically, the authors found that industries that have a greater proportion of workers who change jobs without a period of unemployment are more likely to convert their DB plan to cash balance plans which are more similar to the DC plans.

[24] Similarly, a Fidelity Investments survey found that 36 percent of 401(k) participants had no greater than five years of tenure with the plan sponsor as of year-end 2006 (Fidelity Investments, 2007). Also, a 2007 study by Copeland noted that the median tenure for all wage and salary workers (regardless of retirement plan arrangements) age 25 or older has remained virtually unchanged from 1983 (five years) to 2006 (4.9 years).

plans. Based upon the evidence provided, it would seem that while the PPA 2006 may increase the speed at which firms move towards greater participant flexibility when dealing with company stock, participant inertia and increasing workforce mobility still create significant ERISA liability exposure for plan sponsors. Looking at fiduciary liability insurance coverage prior to the passage of the PPA 2006, it should be noted that since 2005, the market for this coverage remained relatively stable.[25] It may be inferred that part of this stability in the market for these products is due to plan sponsors preemptively attempting to reduce liability exposures by reducing or eliminating the use of company stock in 401(k) plans prior to the PPA 2006. If this is the case, the fiduciary liability market may not be noticeably impacted by the passage of the Act because employers were already moving in the prescribed direction for liability mitigation.

Company Stock and Retirement Plans

With the passage of the Pension Protection Act occurring over one year ago, it is interesting to look at the current condition of company stock and retirement plans to determine how firms have responded both to the large number of stock-drop lawsuits that have occurred and the passage of the Act. Looking at the issue of investment options, it appears that employers are beginning to increase the number of premixed portfolio's and the number of investment options. As noted by Hewitt Associates, 77 percent of employers are offering a premixed portfolio and the average number of investment options has increased from 14 to 17 in the past two years (2007).[26] Prior to the Enron

[25] A January 2006 Arthur J. Gallagher Risk Management Services report noted that while conditions were stable for those with no or minimal tag-along claim exposure, hard market conditions still existed for those firms with more significant tag-along claim exposure (MacLeod, 2006).

[26] Premixed portfolios are portfolios consisting of target-risk and/or target-maturity funds. The Hewitt Associates study notes that when excluding premixed portfolios, the average investment options have increased from 10 to 12 over the previous two years.

debacle in 2001, plan sponsors were generally offering approximately 11 investment alternatives (Profit Sharing Contribution/401(k) Council of America, 2000). This may indicate that employers are becoming more cognizant of the benefits of greater diversification opportunities, both for the sponsor and its participants. While plan participants are seeing an increase in the number of investment options available, as of 2007, employer stock remains an important investment option, being available as an option within 46 percent of 401(k) plans.

In addition to increasing investment options, in 2007, plan sponsors continued the move away from matching exclusively with company stock. This is evidenced by a recent Hewitt Associates report which finds that only 23 percent of plans offering employer stock as an investment option make matching contributions exclusively in company stock. This appears to be a significant decline when compared to the 36 percent matching exclusively with company stock in 2005 and 45 percent in 2001.

With respect to the ability to diversify company matched stock, it appears that many firms had already begun to increase the level of flexibility with respect to company stock divestitures prior to the passage of the PPA in 2006 (Chen, 2002). As noted previously, in 2001 only 15 percent of employees were capable of divesting their employer stock holding at any time, and the number of companies allowing undeterred diversification increased to 24 percent in 2005. The most recent study of this issue reports this number increased to 67 percent in 2007.

Finally, according to an Employee Benefits Research Institute report, in 2007, company stock made up a total of 11 percent of 401(k) plan assets. This is a large reduction when compared to the pre-Enron value of 19 percent investment in company

stock in 2000 and the pre-PPA 2006 value of 13 percent. [27] The above would appear to indicate that the while the PPA 2006 certainly exacerbated the speed at which firms offered greater plan participant flexibility with respect to company stock, plan sponsors still face potential liability issues stemming from the inclusion of company stock in their plans. This is because the decreased percentage of 401(k) assets held in company stock still represents millions of employee retirement dollars. As such, it should come as no surprise that while firms do continue to maintain ERISA liability exposure as a result of company stock, the market for fiduciary liability appears to have remained mostly unaffected by the passage of the PPA 2006. Specifically capacity, coverage, and premiums all remain fairly stable due, in large part, to the fact that sponsors were already removing significant ERISA-related liability exposures prior to the passage of the Act.[28]

Future Implications

While Section 901 will allow plan participants the ability to divest out of company stock after a period of three years, research in this area does not support the position that participants will necessarily take advantage of this option. Specifically, literature exists which indicates that participants may not make optimal changes to their retirement accounts (Choi, Laibson, Madrian, and Metrick, 2001). In addition, researchers have found a great deal of 401(k) participant "inertia", with nearly 90 percent of employer-sponsored retirement plan participants making no trades in a given year

[27] Using a different sample, Hewitt Associates found that 42 percent of 401(k) assets were maintained in company stock in 2001. In 2002, Hewitt Associates found that this number declined to 28 percent, and in 2007 Hewitt Associates found this value had declined to 16 percent (Morgenson, 2003).

[28] A 2008 Arthur J. Gallagher Risk Management Services Inc. market report indicates that publicly-traded firms with tag-along claim exposures as a result of ERISA litigation should expect a reduction in premiums while those without such exposure that have not experienced dramatic premium increases should anticipate flat to relatively modest reductions in premiums at renewal (MacLeod, 2008). These decreases are attributed to the large number of tag-along claims that have been settled and the fact that the settlements were much smaller than had been anticipated.

(Agnew, Balduzzi, and Sunden, 2003). Thus, even with plan sponsors attempting to actively reduce 401(k) plan-related risks, the inclusion of company stock as an investment option still creates the potential for ERISA stock-drop litigation.

While the PPA 2006 provisions provide employees with more information and more flexibility with the management of their 401(k) plans, it may adversely affect their ability to claim breach of fiduciary duty. As noted previously, there are essentially three claims that are made with respect to ERISA breach of duty litigation. With the passage of the PPA 2006, the argument that the firm knew that the inclusion of company stock as a 401(k) investment was not prudent should diminish, as the participants are now able to remove this investment from their portfolios within a fairly short time frame. Furthermore, for plan sponsors that no longer offer company stock as an investment alternative, this argument is no longer valid. However, participants will still be able to maintain that firms did not provide material information or provided misinformation and that the employer did not monitor fiduciaries. While the PPA 2006 does require that plan sponsors inform participants of the benefits of diversification, this is not required until 30 days prior to the required allowance of company stock divestiture. In the same light, while the PPA 2006 does allow firms to provide participants with investment advice, firms are not required to do so. Thus, although the likelihood of being found legally liable should decrease with the passage of the PPA 2006, there still appears to be many opportunities for these types of lawsuits. As such, the demand for liability products that offer protection for this type of exposure should at the very least remain constant and may increase as additional exposures related to company stock in 401(k) plans surface.

Conclusion

The twenty-first century greeted U.S. investors with a number of much publicized corporate failings involving fraud and deception which resulted in a plummeting stock market and subsequent litigation on behalf of individuals participating in employer-sponsored retirement plans. While a number of laws, such as Sarbanes-Oxley and the Pension Protection Act of 2006, were enacted in an effort to increase confidence among both investors and retirement plan participants, the inclusion of company stock in employer-sponsored retirement plans still creates a situation where the sponsor may, at the very least, be charged with failure to meet fiduciary obligations.

While Sections 901 and 507 of the PPA 2006 were designed to improve the retirement security of Americans and may provide a greater defense against stock-drop related lawsuits, the potential still exists for sponsors to be held liable when the market is performing poorly and when plan sponsors do not focus enough on mitigating ERISA legal liability. As long as the market fluctuates and plan sponsors continue to include employer stock as an investment option, retirement plan sponsors, fiduciaries, and professional liability insurers will still have to deal with the very real possibility of stock-drop litigation and the financial consequences that such litigation entails.

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