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The Enron Bankruptcy and Employer Stock in Retirement Plans

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Summary

On December 2, 2001 the Enron Corporation filed for Chapter 11 bankruptcy protection in federal court in New York. Enron sponsors a retirement plan – a "401(k)" – for its employees to which they can contribute a portion of their pay on a tax-deferred basis. As of December 31, 2000, 62% of the assets held in the corporation's 401(k) retirement plan consisted of shares of Enron stock. Some Enron employees held even larger percentages of Enron stock in their 401(k) accounts. The company's bankruptcy substantially reduced the value of many of its employees' retirement accounts. Shares of Enron, which in January 2001 traded for more than $80 per share, were in January 2002 worth less than 70 cents each. The financial losses suffered by participants in Enron's 401(k) plan have prompted questions about the laws and regulations that govern these plans. This CRS Report describes the current laws governing the holding of employer stock in employee retirement plans and summarizes some key policy questions that pension analysts have raised about holding such stock in defined contribution retirement plans. This report will be updated as further legislative developments occur.

The two kinds of retirement plans. Sponsorship of retirement plans by employers is voluntary, but any firm that sponsors a plan for its employees must abide by the standards established under the *Employee Retirement Income Security Act of 1974* (P.L. 93-406), popularly known as ERISA. In order for a plan to be tax-qualified – that is for contributions to the plan and investment earnings on those contributions to be eligible for deferral of federal income taxes – the plan must also comply with the relevant sections of the *Internal Revenue Code of 1986.* Retirement plans are legally classified as either *defined benefit* plans or *defined contribution* plans. In a defined benefit plan, an employer pays retired workers a pension benefit based on a pre-determined formula, usually related to the employee's length of service and average salary in the years immediately preceding retirement. Each year, the employer must contribute money to a *pension trust* to fund the retirement benefits that the firm's employees earned that year. A trustee or other fiduciary appointed by the employer determines how to invest those funds. (A fiduciary is an individual, company, or association responsible for managing another's assets). Broad guidelines prescribed by federal law require the funds to be invested solely in the best interests of the workers and retirees covered by the plan.

A *defined contribution* plan is much like a savings account maintained by the employer on behalf of each participating employee. The most common defined contribution plan, is the "401(k)" plan, named for a section of the Internal Revenue Code that was added by the *Revenue Act of 1978* (P.L. 95-600). In a 401(k) plan, the employee can make pre-tax contributions to a retirement account. These contributions are often matched by the employer in whole or in part up to some percentage of the employee's base salary. Typically, participants can allocate the investment of their account balances among a menu of investment options selected by the employer and/or fiduciaries appointed by the employer. Employer stock is frequently one of those options. The value of the retirement benefit that the worker receives will depend on the balance in the account, which is the sum of all the contributions that have been made plus interest, dividends, and capital gains (or losses). The worker usually has the choice of receiving these funds in the form of a life-long annuity, as a series of fixed payments over a period of years, or as a lump sum.

In recent years, some employers have converted their traditional pensions to *hybrid plans* that have characteristics of both defined benefit and defined contribution plans. The most popular of these hybrids has been the *cash balance plan*. A cash balance plan looks like a defined contribution plan in that the accrued benefit is defined in terms of an account balance. The employer makes contributions to the plan and pays interest on the accumulated balance. However, in a cash balance plan, the account balances are merely a record of the participant's accrued benefit. They are not *individual accounts owned by the participants*. Legally, therefore, a cash balance plan is a defined benefit plan.

The Locus of Risk in DB and DC Plans. In a defined benefit plan, the *employer* bears the investment risk of the plan, while in a defined contribution plan the *employee* bears the investment risk. In a defined benefit plan, the employer promises to provide a retirement benefit equal to a certain dollar amount or percentage of the employee's pay. The employer contributes money to a pension trust that is invested in stocks, bonds, real estate, or other assets. Retirement benefits are paid from this trust fund. The employer is *at risk* for the amount of retirement benefits that have been promised to employees and their survivors. If there are insufficient funds in the pension trust to pay the accrued benefits, the firm that sponsors the pension plan is legally obligated to make up the difference by paying more money into the pension fund.

In a defined contribution plan, the employer bears no risk beyond its obligation to make the contributions it has promised to each employee's retirement account. In these plans, it is the employee who bears the risk that his or her retirement account will increase in value by an amount sufficient to provide adequate income during retirement. If the contributions made to the account by the employer and the employee are insufficient, or if the securities in which the account is invested lose value or increase in value too slowly, the employee risks having an income in retirement that is not sufficient to maintain his or her desired standard of living. If this occurs, the worker might choose to delay retirement.

The Pension Benefit Guaranty Corporation. The Pension Benefit Guaranty Corporation (PBGC) is a federal government corporation established by ERISA to insure pension benefits in private-sector defined benefit plans. By law, the PBGC insures *only* defined benefit plans. It does not insure defined contribution retirement plans, such as profit sharing plans or 401(k) plans. The PBGC currently insures pension benefits for more than 43 million workers in almost 38,000 private-sector defined benefit pension plans. The insurance provided by the PBGC is financed through premiums levied on all private-sector defined benefit pensions. This premium, set by Congress, is $19 per year per participant. An additional premium of $9 per $1,000 of unfunded vested benefits is levied against under-funded plans because these plans present the greatest risk of default.

When a fully funded plan terminates – perhaps because an employer chooses to end the pension plan – the plan provides benefits either by purchasing an annuity from an insurance company or by paying out the benefits owed to each participant in a lump-sum. When an underfunded plan terminates – either because the employer is unable to properly fund the plan or because the PBGC ends it to protect the interests of participants or the PBGC – the PBGC takes over the plan as trustee and uses its own assets and any remaining assets in the plan to make sure that participants will receive pension benefits, within legal limits. The PBGC's maximum benefit guarantee is set each year under provisions of ERISA. For pension plans that end in 2002, the maximum guaranteed benefit is $3,579 per month for a worker retiring at age 65. The guarantee is lower for payments beginning before age 65 or if the pension includes benefits for a survivor.

Employer Stock in Retirement Plans. ERISA limits the amount of employer stock that can be held in a *defined benefit* plan to 10% of plan assets to ensure that the assets of pension trust funds are diversified beyond the assets of the company itself.[1] Such diversification reduces the risk that a pension fund would become insolvent as a result of the company that sponsors the plan going bankrupt. Congress has generally exempted defined contribution plans from limits on investing in employer stock,[2] except for certain plans that require salary deferrals equal to more than 1% of employee pay to be used for purchasing employer stock.[3] **H.R. 3463** (Deutsch) would limit employer stock to 10% of the total assets in a 401(k) plan that are attributable to *employee* contributions. Employer contributions would not be subject to the limit. **S. 1838** (Boxer) and **H.R. 3640** (Pascrell) would limit employer stock to 20% of the assets held by any individual in a 401(k) plan.

Should employee ownership of employer stock in a 401(k) be limited to some fixed percentage of the total? As of December 31, 2000, 62% of the assets in the Enron Corporation's 401(k) plan consisted of shares of Enron stock.[4] The company has estimated that 89% of this stock was purchased by employees and that the remainder represents the corporation's matching contributions to the plan, most of which were made in the form of shares of Enron stock.[5] It is not unusual for defined contribution plans to hold employer stock that comprises more than 10% of the plan's assets. According to a survey of 428 employers conducted by the benefits consulting firm Hewitt Associates, 29.6% of the assets of these firms' 401(k) plans was invested in the employer's stock as of October 31, 2001. Fifty-five percent of plans offered the employer's stock as an investment option. Among those plans, 45% made the employer's matching

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[1] 29 U.S.C. §1107(a).

[2] 29 U.S.C. § 1104(a)(2) and § 1107(b).

[3] 29 U.S.C. § 1107(b)(2).

[4] S.E.C. Form 11-K for the *Enron Corporation Savings Plan*, Commission file number 1-13159.

[5] "Employees' Retirement Plan Is a Victim as Enron Tumbles," *The N.Y. Times*, Nov. 22, 2001.

contribution exclusively in the company's stock. Some employers voluntarily limit the amount of employer stock that participants can hold in their 401(k) accounts, but most do not. According to the survey conducted by Hewitt Associates, only 14% of the companies surveyed restrict the amount that employees can invest in employer stock. The most common limit is 25%. Another recent survey found that the concentration of employer stock in some 401(k) plans is greater than 50% of total 401(k) assets. (See **Table 1**.)

Table 1. Employer Stock in Selected Retirement Plans

Company name	Company stock as a percentage of defined contribution plan's assets:	Does company have a defined benefit plan?
Procter & Gamble	91.5%	No
Anheuser-Busch	81.6%	Yes
Coca-Cola	81.0%	Yes
Abbott Laboratories	80.0%	Yes
General Electric	77.4%	Yes
William Wrigley, Jr.	75.0%	Yes
Pfizer	74.8%	Yes
Home Depot	72.0%	No
BB&T (Branch Banking & Trust)	69.6%	Yes
Texas Instruments	69.0%	Yes
Duke Energy	67.9%	Yes
Target	66.0%	Yes
Textron	65.0%	Yes
Reliant Energy	64.5%	Yes
Kroger	63.6%	Yes
Southern Company	62.8%	Yes
ExxonMobil	62.0%	Yes
Household International	61.4%	Yes
Sherwin-Williams	59.1%	Yes
BellSouth	57.9%	Yes
Merck	57.5%	Yes
Williams	57.0%	Yes
McDonald's	56.8%	No
TXU (Texas Utilities)	56.3%	Yes
Dell Computer	53.4%	No
Ford Motor Company	50.2%	Yes

Source: S.E.C. Forms 10-K and 11-K and company spokespersons.

Should there be restrictions on employer contributions to 401(k) plans in the form of company stock? Some employers make all or part of their contributions to their employees' 401(k) accounts in the form of company stock. Some also offer company stock as an investment option that employees can purchase for their 401(k) accounts. Contributing company stock is popular with employers because, when it consists of newly-issued shares or shares from the company's treasury, it does not reduce the company's cash flow. Moreover, as with cash contributions, stock contributions are fully deductible as a business expense for income tax purposes. Making contributions of stock also puts shares into the hands of a group of people – the firm's employees – who are less likely to sell their shares either when there is a hostile tender offer for the company or when the firm's reported profits are less than expected. Some observers contend that if companies were forced to contribute cash rather than stock, many companies might stop making matching contributions to their 401(k) plans. Others point to research suggesting that workers whose employers make matching contributions with company stock are more likely to put their own contributions into company stock, thus risking substantial losses from a decline in the price of their employer's stock.[6] Under **S. 1992** (Kennedy), a defined contribution plan could either (1) permit employees' elective deferrals to be invested in employer securities or (2) make the employer's contribution in employer securities, but not both.

Should there be limits on when and how long employers can suspend 401(k) transactions? Companies sometimes suspend transactions in their 401(k) accounts, most commonly when they are changing plan administrators, installing new software, or performing other routine administrative tasks that require a temporary suspension of account activity. According to the Office of Regulations and Interpretations of the U.S. Pension and Welfare Benefits Administration, there is no statutory or regulatory limit on the length of time during which participants can be blocked from re-allocating assets or conducting other transactions in a 401(k) plan.

Plan sponsors and administrators have certain rights and responsibilities as fiduciaries of the plan, such as crediting each individual participant's account with contributions and recording investment earnings or losses. Fiduciaries therefore have the right to take reasonable actions to ensure that these and other administrative tasks are carried out in an orderly and efficient manner. Nevertheless, when a plan sponsor suspends transactions, it still must act in the interest of the plan participants. ERISA § 404(c)(1) states that when a plan "permits a participant or beneficiary to exercise control over the assets in his account," neither the plan sponsor nor the plan administrator are liable for investment losses that the participant may incur. Whether the plan sponsor or administrator is relieved of such responsibility depends in part on the ability of the participant "to exercise control over the assets in his account." In a lawsuit filed against the Enron Corporation, plan participants have alleged that the company deprived plan participants of control over their accounts by "locking down" the plan – i.e., prohibiting re-allocation of assets – during a period of time when revelations about the company's finances were causing the share price of Enron stock to fall. They argue that during the lockdown, the plan assets were under the control of the plan sponsor rather than the plan participants. Therefore, they contend, the plan sponsor should be held legally responsible for carrying out the fiduciary duty for *diversification of plan assets* defined at ERISA § 407(a)(2). **H.R. 3509** (Bentsen) would require 401(k) plan sponsors to secure permission from the Department of Labor before suspending transactions in the plan and to provide 90 days notice of any suspension. **H.R. 3657** (Miller, CA), **H.R. 3762** (Boehner), **S. 1919** (Wellstone), **S. 1921** (Hutchison), **S. 1969** (Hutchinson), **S. 1971** (Grassley) and **S. 1992** (Kennedy) would require plans to give participants written notice 30 days before a lockdown begins. **H.R. 3657** and **S. 1919** would limit lockdowns to no more than 10 consecutive business days.

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[6] Shlomo Benartzi, "Excessive extrapolation and the allocation of 401(k) accounts to company stock," *The Journal of Finance*, Vol. 56, No. 5, October 2001.

Should employers be able to compel employees to hold on to employer contributions of company stock until age 50 or later? Plan sponsors can require participants to hold on to employer stock contributed by the employer. According to the Hewitt Associates survey, 34% of 401(k) plans that match employee contributions with employer stock require participants to reach a certain age – typically 50 or 55 – before they can sell it. Of the firms that match with employer stock, only 15% allow their employees to sell the stock immediately. Nineteen percent do not permit diversification at any time. According to a study of 401(k) plans by Fidelity Investments, only 4% of plans that match with company stock let participants immediately sell those shares. Employees participating in Employee Stock Ownership Plans (ESOPs) are permitted to begin diversifying their holdings of employer stock when they have completed at least 10 years of participation under the plan and have attained age 55 (26 U.S.C. § 401(a)(28)). In 1997, a majority of the Pension and Welfare Benefits Administration Advisory Council working group on employer assets in ERISA plans recommended that participants in 401(k) plans should be able to sell employer stock when they become vested in the plan.[7] **S. 1838** and **H.R. 3640** would permit vested participants to sell employer stock 90 days after it is credited to their 401(k) accounts. **H.R. 3463** would allow participants in 401(k) plans to sell employer stock 3 years after the stock is contributed to their accounts. **H.R. 3657** would permit vested participants to sell employer stock 30 days after it is credited to their 401(k) accounts. It also would reduce the maximum vesting period for defined contribution plans from three years to one year.

Should 401(k) accounts be insured by the federal government? Defined benefit pensions are insured by the Pension Benefit Guaranty Corporation, which was established by ERISA in 1974. Insuring defined contribution plans would raise several difficult questions about the specific kinds of risk to be insured against. (1)Would investors be insured only against losses directly attributable to the collapse of their *employer's shares*? In that case, regulating risk by requiring diversification would be simpler and cheaper than insuring defined contribution plans. (2) Would investors be insured against wider *investment risk*, such as business failures in particular industries or sectors of the economy in which they had invested? (3) Would investors be insured against *market risk*, such as a general decline in stock prices? In any case, it would be challenging to price the insurance appropriately. All 401(k) investors would ultimately pay for the insurance through higher administrative fees, reduced employer contributions, or both.

In addition to defining the specific risks to be insured against, there is the potential problem that offering insurance for 401(k)s might actually *encourage* workers to engage in risky investment behavior, something that insurers call *moral hazard*. Investors might choose to invest in companies that are especially risky because they would have nothing to lose. The effects of offering insurance for 401(k) plan losses could lead to events similar to the savings-and-loan crisis of the 1980s. Depositors were willing to place their money with risky savings and loans – those that paid the highest interest rates – because they knew that if the S&L failed, they would get their money back from the federal government through federal deposit insurance. **H.R. 3657** and **S. 1992** would direct the PBGC to study the feasibility of a system of insurance for defined contribution retirement plans.

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[7] Pension and Welfare Benefits Administration Advisory Council on Employee Welfare and Pension Benefits Plans, Report of the Working Group on Employer Assets in ERISA Employer-Sponsored Plans, November 13, 1997. [http://www.dol.gov/dol/pwba/public/adcoun/acemer.htm].