

2014

Rethinking ERISA's Promise of Income Security in a World of 401(k) Plans

Lawrence A. Frolik

Follow this and additional works at: <https://opencommons.uconn.edu/cilj>



Part of the [Insurance Law Commons](#)

Recommended Citation

Frolik, Lawrence A., "Rethinking ERISA's Promise of Income Security in a World of 401(k) Plans" (2014).
Connecticut Insurance Law Journal. 125.
<https://opencommons.uconn.edu/cilj/125>

RETHINKING ERISA'S PROMISE OF INCOME SECURITY IN A WORLD OF 401(K) PLANS

LAWRENCE A. FROLIK*

This article discusses the evolution of retirement income funds from defined benefit packages to 401(k) and IRA accounts and how the changing dynamic has reshaped the way retirees think about post-retirement income. The article outlines the mechanics of 401(k) accounts and rollover IRAs in the post-retirement period and presents questions about the ability of retirees to successfully address the complex issues relating to investment choices including, what entity they entrust their savings to, the volume and source of distributions, and long-term sufficiency planning. The article suggests that an increase in the use of annuities may help to resolve some of the challenges faced by today's retirees.

I. THE DECLINE OF THE DEFINED BENEFIT PLAN.

Over the last twenty years the number of defined benefit plans has steadily declined; as of 2011, fewer than twenty percent of all employees participated in one.¹ Defined benefit plans are being replaced by defined contribution plans: more specifically, 401(k) plans in the private sector, 403(b) plans by tax exempt organizations or public schools, and 457(b) plans for some state and local governmental employees.² (For brevity, these plans will collectively be referred to as 401(k) plans.) Participation in 401(k) plans has steadily risen so that over fifty percent of employees participate in one.³ The dollar amount saved in those accounts is

* Professor of Law and Distinguished Faculty Scholar, University of Pittsburgh School of Law.

¹ U.S. BUREAU OF LABOR STATISTICS, *The Last Private Industry Pension Plans*, (2013), http://stats.bls.gov/opub/ted/2013/ted_20130103.htm.

² The plans take their names from the Internal Revenue Code sections that govern them: I.R.C. § 401(k) (2010), I.R.C. §§ 403(b), 457(b) (2008).

³ William J. Wiatrowski, *Changing Landscape of Employment-Based Retirement Benefits*, U.S. BUREAU OF LABOR STATISTICS (2011), <http://www.bls.gov/opub/cwc/cm20110927ar01p1.htm>.

astounding. As of December 2010, defined contribution plans held \$4.5 trillion.⁴

Employers often cite investment risk as a compelling reason for abandoning defined benefit plans and replacing them with 401(k) plans.⁵ Employers who sponsor a defined benefit plan must annually fund it with the amount due based on several variables, including the probable amount of the defined benefit or pension owed to each retiring employee, the life expectancy of the retired employees and other plan beneficiaries, and the expected investment return on the plan assets. The latter, the return on the plan investments, can cause the greatest year-to-year variance in the employer's required annual plan contribution. The higher the investment return, the fewer dollars that the employer must contribute to the plan. During years of high interest rates on bonds and strong returns on stocks, the employer may need to contribute little or nothing to the plan. But in years of low interest rates on bonds and losses from stock investments, the employer will have to make significant contributions in order to keep the plan actuarially fully funded. Over time, of course, the good investment years and the bad investment years off-set each other, so that over the life of the plan, the pension fund should have an acceptable average return. "Over time," however, provides little comfort to the employer during the years of poor or negative investment returns, which will mandate greater employer contributions to the plan. It is that short-term risk, which may not be all that "short," that employers, or more accurately, the corporate executives, fear.

The swings in the plan investment return and the corresponding changes in the required employer annual contribution affect the employer's annual profit because the plan contributions are expenses that reduce income. Worse, the employer will likely be forced to make greater contributions in years when the economy is doing poorly, causing the investment returns to lag. Moreover, if the economy is performing poorly, the employer's business may also be suffering. Faced with lower revenues and declining profits, the employer will be required to make larger contributions to the plan, thereby further depressing profits.

In response, employers have turned to defined contribution plans, specifically 401(k) accounts, which do not promise a pension or other form

⁴ INV. CO. INST., 2011 INV. CO. FACT BOOK 102 (51st ed. 2011).

⁵ For a detailed discussion on why employers prefer defined contribution plans to defined benefit plans, see Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451 (2004).

of assured retirement benefit, but only promise the participating employee that the employer will make contributions to the employee's 401(k) account. The employee is then responsible for investing the funds in the 401(k) account. Because the success of those investments largely determines the value of the account at the time the employee retires, the investment risk is shifted from the employer to the employee. Moreover, the employer has a fixed, predictable cost because its contribution is usually a percentage of the employees' pay for those employees who choose to participate.

This shift of the investment risk to the employee is well understood, as well as the risk of participation, the risk of not participating at the maximum degree allowed by the plan, and the risk of borrowing from the 401(k) account.⁶ Post-retirement risks faced by 401(k) participants has failed to garner much attention.⁷ The realities of the post-retirement world create substantial risks that threaten to lead to the impoverishment of many elderly retirees.

II. THE RISE OF THE ROLLOVER INDIVIDUAL RETIREMENT ACCOUNT

Upon retirement, employees who own a 401(k) account have the option of leaving their account in the employer's 401(k) plan or, as most do, rolling it over, tax-free, into an Individual Retirement Account (IRA).⁸ In 2011 rollover IRAs had a total value of \$4.7 trillion.⁹ (In this paper, retiree defined benefits retirement accounts, whether remaining in the 401(k) or rolled over into an IRA, will be referred to as IRAs.)

⁶ Joellen Leavelle, *Borrowing Against the Future with a 401(k) Loan*, PENSION RIGHTS CTR. (Apr. 12, 2013), www.pensionrights.org/blog/borrowing-against-future-401k-loan; James J. Choi et al., *\$100 Bills on the Sidewalk: Suboptimal Investment in 401(k) Plans*, 93 REV. ECON. & STAT. 748, 748-49 (2011). Most retirees will also have insufficient funds in their 401(k) account to support an adequate income during retirement. See James Kwak, *Improving Retirement Savings Options for Employees*, 15 U. PA. J. BUS. L. 483, 489 (2013).

⁷ But see Lawrence A. Frolik, *Protecting Our Aging Retirees: Converting 401(k) Accounts Into Federally Guaranteed Lifetime Annuities*, 47 SAN DIEGO L. REV. 277 (2010).

⁸ I.R.C. § 402(c)(2) (2005).

⁹ INV. CO. INST., *supra* note 4.

Whether they leave their funds in the 401(k) or roll them over into an IRA, retirees face formidable financial planning hurdles.¹⁰ They must successfully invest the IRA for what is likely to be twenty or more years of their remaining lives, as the average life expectancy at age sixty-five is about nineteen years for men and twenty-one years for women.¹¹ For many, post-retirement will last much longer, as about twenty-five percent of today's sixty-five-year-olds will live past age ninety and ten percent, a majority of whom will be women, will live past age ninety-five.¹² To maintain the value of their retirement fund during their retirement years, retirees must successfully invest it, which at a minimum means earning an investment return at least equal to the rate of inflation. As the financial collapse of the markets in 2001 and 2008 demonstrated, however, even that modest goal may be difficult to achieve. For example, the Dow Jones Industrial average in September 2008, was 13,896. In February 2009, it was 7,069, and in February 2013, it had reached 13,973. Thus, ignoring possible dividends, an investor whose stock portfolio resembled the Dow Jones Industrial Average would have had essentially zero returns for the five-year period from February 2008 to February 2013. Nor would our investor have fared much better by investing in bonds. From 2003 to February 2013, the Vanguard Total Bond fund yielded 5.2 percent, but because inflation from 2002 through 2012 was 2.63 percent, the real annual return on the bonds was less than three percent.¹³

Second, retirees must spend their retirement fund at a rate that will not exhaust it before they die, yet take a sufficient amount out that, when added to their other sources of income such as Social Security, will enable them to live at the level that they deem adequate. Taking money out of a

¹⁰ Even the decision of whether and where to roll over the funds raises difficult choices for retirees. According to the Government Accounting Office, "401(k) plan participants separating from their employers must decide what to do with their plan savings. Many roll over their plan savings to IRAs. As GAO previously reported, there is concern that participants may be encouraged to choose rollovers to IRAs in lieu of options that could be more in their interests." U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-13-30, 401(K) PLAN: LABOR AND IRS COULD IMPROVE THE ROLLOVER PROCESS FOR PARTICIPANTS (2013).

¹¹ SOC. SEC., *Calculators: Life Expectancy*, available at <http://www.ssa.gov/planners/lifeexpectancy.htm> (last visited Feb. 11, 2014).

¹² *Id.*

¹³ VANGUARD, *Vanguard Total Bond Market Index Fund Admiral Shares*, <https://personal.vanguard.com/us/funds/snapshot?FundId=0584&FundIntExt=INT> (last visited Feb. 11, 2014).

retirement account can be even trickier than being a successful investor. Although the two goals (investment returns that at a minimum keep pace with inflation, and taking distributions at a rate that neither exhausts the fund nor leaves the retiree in poverty) can support each other – good investing means more to spend while tempered withdrawals maintain capital – the two goals are also in conflict. The more the retiree withdraws to live on, the less there will be to invest, which will result in less available income in later years.

The percent of the fund that can be taken out each year without exhausting the fund before death is surprisingly low. The current conventional wisdom is to withdraw no more than four percent of the initial fund plus annual increases for inflation.¹⁴ Following that advice would mean that a retiree with an IRA of \$1,000,000 on the first day of retirement could take out only \$40,000 the first year. Even if the retiree was willing to risk exhaustion of the fund by taking out at a rate of five percent, the IRA would yield only \$50,000 a year.¹⁵

Other factors also diminish the income security of a retiree with a 401(k) account. The right upon retirement to take funds from the 401(k) account creates the potential temptation not to save the funds, but to spend them or use them to pay off existing debts.¹⁶ For many retirees, the right upon retirement to take money out of their 401(k) plan is the first time in

¹⁴ See, e.g., Gregg S. Fisher, *What Portfolio Withdrawal Rate Can You Live With?* (Dec. 5, 2012, 2:13 PM), FORBES, available at <http://www.forbes.com/sites/greggfisher/2012/12/05/what-portfolio-withdrawal-rate-can-you-live-with/> (“Our research points to 4% as being a reasonable starting point for a withdrawal rate. Investors should also consider age, health, and other individual-specific issues in determining whether their own withdrawal rate should in fact be lower than this, or possibly higher. But historically, investors with diversified balanced portfolios who took a total return approach to managing their investments in retirement were able to make this 4% withdrawal rate quite consistently.”).

¹⁵ Taking out at a rate of 4% may be too optimistic. The U.S. Department of Labor provides an income calculator that estimates the amount of income that can safely be taken from a retirement account. The calculator uses a rate of interest equal to the 10-year constant maturity Treasury securities rate, which, as of December 3, 2012 was equal to 1.63%, meaning that \$1,000,000 of retirement savings would produce only \$16,300 per year. See *Lifetime Income Calculator*, U.S. DEP’T OF LABOR, <http://www.dol.gov/ebsa/regs/lifetimeincomecalculator.html> (last visited Feb. 11, 2014).

¹⁶ Colleen E. Medill, *The Retirement Distribution Decision Ten Years Later: Results from an Empirical Study*, 16 ELDER L.J. 295, 316 (2009).

their lives they have access to what seems to them to be significant wealth. The temptation is great to spend some of it and so reward themselves for forty-five years of daily toil. Spending any substantial amount of their lump-sum payout, however, will severely affect their future financial well-being. We do not know how often recently retired employees spend part of their 401(k) accounts, but common sense tells us that many may buy a boat or a car or take a special vacation as they celebrate their retirement. Some undoubtedly spend a significant percentage of their 401(k) accounts by “investing” in a better house or vacation home. Others will have debts that they will need to pay off.¹⁷ Regardless of how much is spent or what it is spent on, however, the result is a diminution in future disposable income.

III. WHY PENSIONS ARE PREFERABLE TO 401(K) ACCOUNTS

The Employee Retirement Income Security Act (ERISA), which was enacted to protect the retirement income of employees, was reasonably successful when defined benefit plans prevailed and when retirement plans paid retirees a lifetime pension. In today’s world, however, where defined contribution plans are in the majority, 401(k) plans prevail, and ERISA “income security” ends at retirement when retired employees roll over their 401(k) accounts into IRAs. Once the retiree funds the IRA, ERISA protection ends.¹⁸ As a result, many of America’s retirees will encounter hard times during their retirement.

Consider the meaning of ERISA’s commitment to “income security.” The purpose of ERISA was to help ensure that retirees would receive the retirement benefits promised to them, which in 1974 typically meant a pension paid by a defined benefit plan. ERISA was not enacted as a means of creating wealth for workers that they could pass on to their descendants as a legacy. ERISA was enacted to help assure that retirees would have a dependable source of retirement income that, along with Social Security retirement benefits, would provide economic security

¹⁷ Deanne Loonin & Elizabeth Renuart, *The Life and Debt Cycle: The Growing Debt Burdens of Older Consumers and Related Policy Recommendations*, 44 HARV. J. ON LEGIS. 167, 168 (2007).

¹⁸ IRAs are not governed by the qualified retirement plan regulation of I.R.C. § 401(c). They are governed by I.R.C. § 408. See I.R.C. § 408 (2005); I.R.C. § 401(c) (2004).

during their retirement.¹⁹ When ERISA was enacted, defined contribution plans, though permitted, were in the minority.²⁰ When workers had a choice, as when negotiating their retirement benefits through collective bargaining, they overwhelmingly bargained for a pension as the best way of creating a financially secure retirement. They preferred a pension because they wanted to replace the loss of income occasioned by retirement, particularly when retirement was often not voluntary but imposed by a mandated retirement age, most commonly age sixty-five.²¹

The concept of the need to replace lost income due to retirement is the foundation of American retirement financial security. The most basic source of income security is the nearly universal Social Security tax on wages, which supports an old age pension.²² Intended as a replacement of income lost due to retirement, its benefits are directly tied to the amount of wages earned during the retiree's working years, with the benefit calculated as a percentage replacement of the highest thirty-five years of earned income that was subject to the Social Security wage tax.²³ Social Security is not a promise of a minimum income for every retiree. That function is performed by the Supplemental Security Income program that pays a modest benefit – in 2013, \$710 a month for a single individual or \$8,520 a year – and is best perceived as an anti-poverty program that provides a very modest degree of financial security.²⁴ In contrast, in 2013, the maximum

¹⁹ James A. Wooten, *A Legislative and Political History of ERISA Preemption, Part 1*, 14 J. PENS. BEN. 31, 32 (2006); David Gregory, *The Scope of ERISA Preemption of State Law: A Study in Effective Federalism*, 48 U. PITT. L. REV. 427, 443–46 (1987) (describing the pension failures that gave rise to the enactment of ERISA).

²⁰ Brendan S. Maher & Peter K. Stris, *ERISA & Uncertainty*, 88 WASH. U. L. REV. 433, 448–49 (2010).

²¹ Until the enactment of the Age Discrimination in Employment Act in 1967 (29 U.S.C. §§ 621–634 (1974)), most employers had the right to terminate employees because of their age.

²² The benefit is payable at age 66 to those eligible. There is no requirement that the recipient retire in order to collect benefits. 42 U.S.C. § 401 (2004).

²³ David Pratt, *Retirement in a Defined Contribution Era: Making the Money Last*, 41 J. MARSHALL L. REV. 1091, 1125 (2008); SOC. SEC. *Frequently Asked Questions*, (Dec. 26, 2013), <https://faq.ssa.gov/ics/support/KBAnswer.asp?questionID=1989&hitOffset=65+36+35+27+23+19+18+13+11+10+8+4+3&docID=4533>.

²⁴ SOC. SEC., *SSI Federal Payment Amounts for 2014*, <http://www.ssa.gov/OACT/cola/SSI.html> (last visited Feb. 17, 2014).

Social Security monthly benefit for a worker retiring at age sixty-six was \$2,533 or \$30,396 a year, which is a replacement percentage of almost twenty-seven percent of the maximum amount of earnings of \$113,700 subject to the Social Security wage tax.²⁵

Employment based pensions, when added to Social Security benefits, were expected to create enough income to permit the retiree to live comfortably. In recognition of the retiree's receipt of Social Security benefits, in calculating the amount of the retiree's pension, the retirement plan can be "integrated" with Social Security; that is, Social Security benefits can be taken into account.²⁶ The right to create a pension benefit formula in light of Social Security benefits only emphasizes how pensions are a means of income replacement. To the extent that Social Security has already replaced lost income, an employer provided pension is relieved of that obligation.

When it became apparent that employer promises of pensions would often not be fulfilled, Congress enacted ERISA. It was meant to strengthen workers' rights by imposing fiduciary obligations on plan administrators and mandate adequate funding to increase the likelihood that pensions would not just be promised, but actually paid. The Pension Benefit Guaranty Corporation (PBGC) was also created to provide assurance that if the plan was unable to meet its pension obligations, at least some of the lost pension income would be replaced.²⁷ With the certain payment of Social Security and the relative security of pension payments, retirees were supposedly assured income for life.

The replacement of defined benefit pensions with 401(k) plans, however, has resulted in an upending of the original goal of income replacement. While 401(k) accounts are often criticized for moving the risk of investment from the employer to the employee, that is only part of the problem arising from the abandonment of pensions. Far more depressing, at least for retirees, has been the end of the national

²⁵ SOC. SEC., *Frequently Asked Questions* (Jan. 7, 2014), <http://faq.ssa.gov/link/portal/34011/34019/Article/What-160-are-160-the-maximum-160-taxable-earnings-amounts-and-the-Social-Security-tax-rate-for-2013>.

²⁶ See generally Patricia E. Dilley, *The Evolution of Entitlement: Retirement Income and the Problem of Integrating Private Pensions and Social Security*, 30 LOY. L.A. L. REV. 1063, 1136-79 (1997).

²⁷ Clare Staub, *Fiduciary Liability Issues in ERISA Pension Plan Terminations*, 11 HOUS. BUS. & TAX. L. J. 427, 430 (2011).

commitment to a guaranteed stream of income secured by ERISA funding requirements, plan administrator fiduciary obligations, and the PBGC.

Rather than promoting retirement income, a 401(k) plan promises the accumulation of a fund that the retiree may draw down and live on during retirement. While in theory a 401(k) plan should be able to serve as a secure source of income in retirement, in reality it will usually not. The difference between a pension – a set amount of annual income for life – and a lump sum that can be converted into a stream of income by annual distributions, is so great that to say that a 401(k) is a replacement for a pension is like saying that an orange is a substitute for an apple because both are fruits. Yes, both a pension and a 401(k) represent a form of wealth, and both can be converted into goods and services in the same way that both oranges and apples can be converted in caloric energy. Other than both providing the opportunity for consumption, however, there is simply no resemblance between a pension and a 401(k) account. The former represents a form of income replacement, while the latter, the 401(k), is a form of wealth accumulation. And while it is true that wealth can be used to replace income, it is not at heart income. Wealth must be managed, invested and husbanded in order for it to produce income during the many years of retirement.

The essence of a pension is its dependable and repetitive nature, so that every dollar received can be used to purchase goods and services, because another dollar, i.e., next month's pension payment, is on the way. That is the good news. The bad news is that the pension benefit is fixed and usually not adjusted to reflect a loss of purchasing power due to inflation, and the death of the pensioner, or the spouse of the pensioner, terminates the benefits. (Though many pensions pay until the last to die of the worker or the worker's spouse, for convenience this paper will refer only to a single pensioner.) Because an ERISA pension is non-assignable and cannot be sold,²⁸ a pension has no present value.

A 401(k) account is the opposite of a pension. Once transferred to an IRA, the funds are assignable, have a present value and maintain that value at the death of the retiree. But the funds, once spent, are forever gone. Every dollar spent is a dollar that will not be replaced. In short, a pension is income, a 401(k) account is wealth. And yes, income can be converted into wealth by not spending it, just as wealth, if spent, can be converted into income. But to save pension income in order to create

²⁸ 29 U.S.C. § 1056(d)(1) (2006).

wealth means the loss of current consumption, which defeats the very reason for the pension – the replacement of income loss due to retirement. And to spend the wealth in a 401(k) plan to create income defeats the core advantage of wealth, the possibility of future consumption either by the current owner of the wealth or by a designated successor.

Pensions, which offer the certainty of income over the life of the retiree or pensioner, meet the challenge of how to pay a fixed level of income for an unknown number of years without assuming any additional funding after the commencement of the pension. There is no risk of running out of income for a retiree because that risk is borne by the payer of the pension, or more correctly the risk is reduced to the risk of the payer not being able to pay the pension because of actuarial miscalculations, lower-than-expected investment returns, or the plan sponsor encountering financial difficulties and so not making required contributions to the plan.

If we conceive of the pension as being a pooling of individual retirement funds by all of the pensioners – albeit contributed by the employer and not the workers – the promise of lifetime income is possible only because of the insurance aspect of the fund. Pensions are a form of pooled risk; the promise of lifetime income to all participants is possible only because of differential dates of death by the participants. Some pensioners will outlive their life expectancy and so receive more value in annual distributions than would be called for based on the dollars that their employer contributed to the pension plan for that individual. Other pensioners will die before their expected life expectancy and so never realize the value of the dollars that were contributed to the fund on their behalf. Those who die before their expected time not only collect a pension for fewer years; they also forfeit what they “paid” to their pension in the form of foregone wages. To the extent their wages were reduced, as the employer shifted their compensation from current wage income to future pension income, pensioners who die early experience an actual loss of lifetime disposable income compared to workers whose employer did not reduce their wages to contribute to a pension plan. In short, a worker enrolled in a pension plan is betting that he or she will live long enough to recapture the loss of current wages in the form of pension income.

A 401(k) account that is rolled over into IRA is the antithesis of the pension plan’s pooled risk; each retiree individually bears the risk of living beyond his or her life expectancy and so exhausting the IRA. The uncertainty of when death may occur and the “risk” of a long life means a retiree cannot spend all of his or her IRA and must hold back some of it in order to guarantee that the fund will not be exhausted before death,

meaning that not all the 401(k) account is available for consumption during retirement.

The uncertainty of when death will occur and the lack of “income insurance” for the long-living retiree results in a pension having a greater worth than an IRA of a similar dollar value. On the first day of retirement, if a pension is discounted back to present value, and that value is equal to the present value of a rollover IRA, the pension will provide more annual income for consumption than the IRA because, unlike the IRA, every dollar of the pension is available for consumption. A pension plan, which has sufficient participants to effectively spread the actuarial risk, can calculate the annual payoff that will exhaust the allocated capital for each participant at the average expected date of death of the plan participants knowing that the “early” deaths of participants and the resultant savings of capital will counterbalance the “late” deaths and so ensure sufficient funds to pay every participant a pension for life. The ability to payout all of the capital is what makes a pension inherently more valuable in terms of consumption to a retiree than a rollover IRA, which the retiree cannot spend down to zero because the retiree does not know when death will occur.

Of course, by not spending all the capital in an account, the IRA owner has funds to pass on after death. The dollar amount of what is passed on will be an actual number, but the value to the IRA owner of passing on funds to another will vary according to the value to the IRA owner of leaving a legacy. Some place a high value on doing so, while others prefer to consume more of the IRA during their life rather than passing that consumption opportunity as a legacy on to another.

The legacy advantage of an IRA is not unique, however, because it can be achieved by a pensioner by the purchase of life insurance. Assuming upon retirement that the pensioner is insurable, he or she can purchase life insurance, whose annual premium will reduce consumption but ensure a legacy. By doing so, a pensioner might end up with a level of annual consumption that is close to the amount of an annual distribution from an IRA that can safely be taken out over the life of the owner. Similarly, an IRA owner can capture the value of a pension by using the IRA to purchase an immediate pay, lifetime annuity, but the transaction costs associated with purchasing an annuity and the conservative future rate of interest assumed by the seller of the annuity will likely result in a lower annual payment than if the same amount in the IRA had been contributed annually to a defined benefit plan and used to finance an annual pension.

It is not the marginally lower return of an individually purchased annuity, however, that accounts for the lack of purchases by IRA owners.²⁹ Scholars of behavioral economics tell us that a variety of psychological traits, such as hyper-discounting of future income, the common reluctance to exchange a very large amount of money for a future stream of income, over-confidence as to the ability to invest, excessive optimism as to rate of return on investments, and underestimating life expectancy, are so deeply inured that it is unlikely that immediate pay annuities will ever find a significant market with IRA owners.³⁰ The result is that most IRA owners do not purchase an annuity and so must manage their accounts during their retirement.

IV. HOW SUCCESSFUL ARE RETIREES IN MANAGING A ROLLOVER IRA?

Upon retirement, the individual can rollover a 401(k) account into a tax-free IRA.³¹ A retiree who decides to rollover a 401(k) account into an IRA must decide where to roll over the funds. There is no shortage of choices; mutual funds, banks, investment advisors, and investment companies all compete for 401(k) accounts dollars, which is hardly a surprise given the opportunity for fees and commissions for the custodian of the IRA. We know very little as to how employees choose the repository of a 401(k) rollover. We do not know if they compare costs in the form of fees and commissions, whether they look closely at the investment return, seek safety from fraud or embezzlement, or search out low or high risk investments. Perhaps they just respond to advertisements or merely follow advice from a friend or relative.

We do know that the choice of the investment vehicle is crucial in terms of the investment return. Retirees who choose unwisely may suffer diminished income in their twenty or thirty years of retirement. We also know that the choice is not “one and done.” Hopefully, over time the retiree gains investment sophistication and invests the account more wisely than at the time of the rollover. Unfortunately, inertia usually wins out

²⁹ Wei-Yin Hu & Jason S. Scott, *Behavioral Obstacles in the Annuity Market*, 63 FIN. ANALYSTS J. 71, 79 (2007).

³⁰ See generally GARY BELSKY & THOMAS GILOVICH, *WHY SMART PEOPLE MAKE BIG MONEY MISTAKES – AND HOW TO CORRECT THEM: LESSONS FROM THE NEW SCIENCE OF BEHAVIORAL ECONOMICS* (2010).

³¹ I.R.C. § 402(c)(2) (2006).

over wisdom (assuming that retirees gain investment skill as they age) so that the initial investment decisions are unlikely to be changed.³²

Of course, the need to make successful investment choices is not new, as the employee faced the same decisions when working. What is new is that the retired employee will be withdrawing funds from the account, or at least the annual minimum distribution that is required after age seventy and a half.³³

The required minimum distribution rules, as well as the practical need to take distributions to provide additional income, raise a number of difficult decisions for the IRA owner. Each year the owner must decide from which assets to take distributions. There are several options, including distributing the most risky assets first, proportional distribution by asset, and either first liquidating equities or the fixed income investments. After each distribution, and in light of past investment returns, the IRA owner faces the choice of whether to adjust the asset allocation. The number and complexity of the choices raised by the need to make annual distributions strongly suggests that many older retirees will not be up to the task.

A retiree who owns an IRA faces confusing choices because the “right” answers are dependent on uncertain variables, including future interest rates, future stock prices, the rate of inflation, future income needs, and the life expectancy of the retiree and the retiree’s spouse. Of course, investors of any age can guess wrong as to the direction of the stock market or future interest rates, but a wrong choice by a retiree may result in a loss of capital: a possibly irreversible choice that may significant lower future distributions.

Given the number of variables that impact retirees’ choices as to how to manage their rollover IRAs, it is unlikely that most are making optimum decisions. Even if they make a wise decision, it is not a final decision. Each year a new retiree can make new mistakes. This repeated need to make difficult investment decisions continues throughout the retiree’s life – stretching from retirement at age sixty-five to age eighty-five, ninety-five or even one hundred. Does anyone really think that most ninety-five-year-olds are up to the task of managing an IRA?

³² See Jeffrey Zwiebel, *Corporate Conservatism and Relative Compensation*, 103 J. POLITICAL ECON. 1, 15–16 (1995).

³³ I.R.C. § 401(a)(9) (2006); see also Treas. Reg. § 1.401(a)(9)-9 (2011) (portraying A-2, Uniform Lifetime Table).

V. DIMINISHED PHYSICAL AND MENTAL CAPACITY

Much has been written about how employees lack the ability to sensibly invest their 401(k) accounts during their working years.³⁴ They also fail to contribute as much as they might, too often borrow from the account, and some even deplete it long before retirement by taking hardship distributions.³⁵ The failure to fully participate, lack of investment acumen, and leakage during working years are all significant drawbacks of 401(k) accounts, yet they fail to capture another inherent fundamental flaw.

Surprisingly, little attention has been paid to the inability of many retirees to successfully manage their rollover retirement IRA funds during the long years of their retirement.³⁶ Retirees typically face twenty to thirty years of retirement. During those many years they must continue to successfully invest and manage an IRA. Unfortunately, during their retirement years most retirees are in physical and mental decline, which erodes their investment skills and diminishes the probability that they will successfully manage their retirement account.

Physical decline is a normal part of aging. The loss of hearing, serious vision impairment, loss of physical energy, and loss of short-term memory are all too common with those aged seventy-five and older.³⁷ The degree of decline varies greatly from individual to individual. Some experience only modest physical decline, such as diminished eyesight or loss of hearing. Others suffer from a general loss of energy and growing frailty. A few will suffer serious declines in short-term memory, others will have significant vision problems, such as macular degeneration, and many will have impaired hearing even if they use a hearing aid. It is difficult to believe that those with serious physical declines can successfully manage an IRA. If, because of failing vision, you have difficulty or cannot read, you cannot effectively review your IRA reports.

³⁴ E.g., James Kwak, *Improving Retirement Savings Options for Employees*, 15 U. PA. J. BUS. L. 483 (2013); Jeff Schwartz, *Rethinking 401(k)s*, 49 HARV. J. ON LEGIS. 53 (2012).

³⁵ Thomas Olson, *401(k) Leakage: Crafting a Solution Consistent with the Shift to Employee-Managed Retirement Accounts*, 20 ELDER L.J. 449, 462–65 (2013).

³⁶ One exception is Pratt, *supra* note 23, at 1137–42.

³⁷ Mary Helen McNeal, *Slow Lawyering: Representing Seniors in Light of Cognitive Changes Accompanying Aging*, 117 PENN ST. L. REV. 1081, 1091–98 (2013); Frolik, *supra* note 7, at 292–97.

Poor hearing may mean you do not hear the advice given to you, mishear it, or avoid meetings with advisors because of your difficulty in hearing. If your short-term memory has severely declined and you have trouble reading because of vision problems, you simply will not be able to make considered decisions. Add to this a general loss of vigor, and it becomes apparent that many very old IRA owners are not capable of active, reasoned management of their account.

Chronic illness is the fate of many elderly. They suffer from conditions such as diabetes, rheumatoid arthritis, and congestive heart failure, which rob them of the energy and concentration needed to be a sophisticated investor. Consider an eighty-year-old woman suffering from end stage renal disease, who travels to the dialysis center three days a week. On the other days of the week, is she really going to devote her limited time and energy to her financial affairs? Will she have the concentration and energy to do so? Other elderly persons experience acute illnesses such as cancer, that leave them in pain, disoriented by drugs or other therapies, and much more concerned about whether they will live than whether their IRA is overloaded with equities or worried about which assets should be sold to provide cash for the annual required minimum distribution.

Even more chilling is the specter of millions of IRA owners who suffer progressive dementia. It is estimated that up to half of those age eighty-five or older suffer from dementia.³⁸ At its most severe, dementia and related illnesses such as Parkinson's leave the victim without the ability to manage even daily expenditures, much less an IRA. It is an odd form of retirement planning indeed to pin the hopes of financial security during retirement on individually managed IRAs, knowing as we do, that a significant percentage of those IRA owners will lose the mental ability to manage those accounts due to dementia. Of course, millions of recipients of pensions will also become demented and lose the ability to handle a monthly pension check. But the risk to a pension recipient is much less. Even if the monthly pension check is lost or misused, another check will arrive next month. But if a demented IRA owner makes investments that result in significant financial losses, there is no additional money coming to the rescue.

³⁸ THE MERCK MANUAL OF GERIATRICS 357 (Mark H. Beers et al. eds., 3rd ed. 2000).

The financial risks to an IRA owner during the early stages of progressive dementia are very great. Dementia or a similar loss of executive functioning can arise from several sources, but the two most prevalent are Alzheimer's and vascular (multi-infarct) dementia. Alzheimer's, the most common form of dementia, is a progressive and irreversible condition that eventually leads to death.³⁹ Vascular dementia, the second most common cause of dementia, is caused by one or more mini-strokes in the brain. While vascular dementia is not necessarily progressive, often the individual experiences additional strokes with a resulting additional loss of mental capacity. The loss of capacity is patchy, as some forms of cognition are unaffected, but the strokes can also cause the loss of physical capability.⁴⁰ The decline in both mental and physical capacity can potentially seriously diminish an individual's ability to effectively manage an IRA.

Whether caused by Alzheimer's or vascular strokes, in its early stages dementia is often not diagnosed. Although some victims of dementia are aware that something is amiss, most do not understand or appreciate that they are losing mental capacity, or they fail to understand the extent of the loss. One of the tragedies of dementia is that it robs its victim of self-awareness and self-judgment. Dementia often waxes and wanes so that the individual may experience times of awareness and realize that they cannot remember some obvious past event or they failed to recognize a good friend on the previous day. But this interval of awareness rarely leads to individuals admitting that they are in mental decline and taking steps to assure that their finances are protected.

Family and friends of individuals with early stages or mild dementia frequently misread it as merely as normal memory loss associated with aging. During the early stages of the disease, the victim can often cover for the deficits; rather than engaging in a conversation, they reply with timeworn clichés or phrases that give the appearance of someone who may be less engaged with the world but is still of sound mind. Some observers perceive the loss of executive functioning as a sign of normal aging or else assume that the older person is merely confused by modern life and new circumstances. Often family members do not want to admit that a parent or spouse is suffering from dementia, and essentially deny the

³⁹ For a detailed discussion of the causes and symptoms of Alzheimer's disease, see JAMES E. SPAR & ASENATH LA RUE, *CLINICAL MANUAL OF GERIATRIC PSYCHIATRY*, 173–220 (2006).

⁴⁰ *Id.* at 242–48.

obvious signs. It seems better to laugh off the confusion and memory loss, which waxes and wanes, and claim that "Mom has good days and bad days," and hope that it is not a progressive condition.

It is during the early stages of dementia that the individual is at particular risk of making misguided decisions about an IRA. Because no one may be aware of the degree of the loss of capacity, the IRA owner will continue to make investment and distribution decisions without anyone raising an objection or intervening. The financial advisor may disagree with IRA owner's decisions, but, absent understanding that the decisions arise from a diminished capacity, the advisor will merely assume that the client has poor judgment. Worse, the individual with early or mild dementia is very vulnerable to financial exploitation and abuse because the loss of capacity leaves the individual less capable of perceiving poor advice or spotting a conflict of interest. The loss of capacity also typically results in the individual being much more susceptible to advice, suggestions and even undue influence from third parties or unreliable sources, such as financial commentators on television or on internet sites. Even family members may take advantage of a confused, forgetful individual suffering from mild dementia by asking for gifts, requesting money for their own investment or business schemes, or even becoming the chief investment advisor (for a fee, of course).

How many IRA owners suffer from some degree of dementia and how much harm that has caused to their accounts is unknown. But statistically we know that millions of older IRA owners have dementia, and we also know that individuals with dementia make poorer decisions and are vulnerable to poor or exploitive advice. So it follows that millions of IRA owners are making poor investment decisions. For an IRA owner not to take steps to assure effective management of the IRA in the event that he or she loses mental capacity reflects a failure to plan for a fairly likely eventuality.

VI. THE LIMITATIONS OF GUARDIANSHIP AND POWERS OF ATTORNEY

The inability of many older individuals to handle their financial affairs has led to the reliance on substituted decision makers: court appointed guardians and agents acting under a power of attorney. Unfortunately, both have serious drawbacks.

A. GUARDIANS

Every state has a guardianship statute that permits a judicial determination that an individual is legally incapacitated and in need of a guardian. Guardianship (called conservatorship in some states) has long been the state response to attempt to protect those who lack mental capacity.⁴¹ At present, the typical statutory test of legal incapacity is the inability of an individual to make reasonable decisions.⁴² If an individual is found to lack mental capacity, the court is empowered to appoint a guardian (or conservator) to act as a substitute decision-maker for the incapacitated individual. The standard of proof of mental incapacity is high because states do not wish to override individuals' autonomy even if they are less mentally capable than they once were or even if they are making questionable financial decisions. Consequently, an IRA owner with diminished capacity might not qualify for the appointment of a guardian even though, because of the loss of mental capacity, his or her investment decisions have been questionable and result in financial losses.

Assuming, however, that a court finds the individual to be mentally incapacitated, the court has the authority to strip the individual of the right to manage an IRA, and all other assets, and appoint a guardian to take over management of the IRA as well as the individual's other assets. The court will grant the guardian sufficient authority to carry out its assigned duties, but usually will not instruct the guardian as to how it should carry out its responsibilities, such as managing an IRA. A guardian is assumed to be capable of protecting the assets of the incapacitated person in an efficient and sensible manner, though a guardian may be subject to some statutory instructions or limitations. Often, for example, a guardian has the authority to spend the income of the incapacitated individual, but must ask the court for authority to spend capital.

Most states expect a guardian to make that decision in accordance with the doctrine of substituted judgment, which requires the guardian to attempt to do what the incapacitated person would have done but for the incapacity.⁴³ The guardian is expected to attempt to ascertain what the

⁴¹ See generally Lawrence A. Frolik, *Plenary Guardianship: An Analysis, A Critique and a Proposal for Reform*, 23 ARIZ. L. REV. 599 (1981).

⁴² E.g., UNIF. PROBATE CODE § 30.1-26-01 (amended 2010).

⁴³ Linda S. Whitton & Lawrence A. Frolik, *Surrogate Decision-Making Standards for Guardians: Theory and Reality*, 2012 UTAH L. REV. 1491, 1494 (2012).

incapacitated person would have done on the basis of his or her prior oral or written statements, any relevant instructions or comments made to financial advisors or others, and by the pattern of prior decisions. For example, if the incapacitated person had invested the IRA exclusively in bonds and eschewed stocks, under substituted judgment, the guardian should continue that investment allocation. Similarly, the guardian should continue to make distributions from the IRA at the same level as in prior years unless the needs of the incapacitated person or his or her spouse suggest larger annual distributions would be appropriate.

The guardian is accountable to the appointing court, perhaps in the form of annual reports, but the level of judicial supervision is usually minimal and largely ineffective because of limited court resources.⁴⁴ It is also not clear how courts expect a guardian to manage an IRA. For example, is a guardian permitted to distribute more than the minimally required annual distribution without prior court approval? The answer likely varies from state to state and may vary from court to court within a state. Guardians, in short, are usually left to their own devices; whether that results in optimal choices about IRA investments and distributions is doubtful.

Guardianship has other drawbacks. The imposition of a guardianship may not be possible even though an individual has diminished capacity, because the appointment of a guardian can only occur if the individual meets the state's statutory test of incapacity. State standards of when a guardian can be appointed are deliberately set fairly high because the state is naturally hesitant to strip an individual of the right to control his or her life. It is thought better to permit individuals with reduced capacity to continue to manage their own affairs so long as they are not putting either themselves or their property at serious risk of harm. Thus, for example, just because an IRA owner puts the funds in more risky investments or comes under the sway of a new financial advisor whose views are out of the mainstream, is not reason enough to impose a guardianship since many IRA owners, who have with no loss of capacity, invest their funds in high risk investments or rely on controversial investment advice.

⁴⁴ Naomi Karp & Erica F. Wood, *Guardianship Monitoring: A National Survey of Court Practices*, 37 STETSON L. REV. 143, 185 (2007).

Even if the court finds the requisite incapacity and approves a guardian, the individual appointed as guardian may lack the knowledge or skill to be an effective manager of an IRA. Typically, the court appoints as guardian the individual nominated in the petition that was filed seeking the imposition of a guardianship. The ability of the individual nominated to wisely manage a retirement IRA undoubtedly varies greatly. Often those nominated are selected more for their willingness and availability to act as guardian rather than for any special financial acumen. Worse, the individual who agrees to act as guardian may agree to do so from a desire to gain some advantage or profit from the assets of the older person rather than using the IRA to promote the interests of the incapacitated person.⁴⁵

B. AGENTS

Because of the costs, complexities, and lack of privacy associated with guardianship, every state has a statute that permits an individual to create a durable power of attorney that appoints an agent to handle financial affairs in the event the principal should be unable to do so. The use of a power of attorney would seem to be the sensible and efficient solution to an older retiree losing the ability to handle a retirement IRA. It is inexpensive because most powers of attorney are based on a form or a standard document, and can be seen as something akin to a private guardianship arrangement, with the agent being comparable to a guardian. The agent takes on his or her duties when the principal is no longer capable of managing his or her financial affairs. There is no judicial involvement involved. The appointment of an agent under a power of attorney is a private solution to a private problem.

Unfortunately, despite the wide use of the durable powers of attorney, no state has succeeded in preventing the misuse of that power by the agent.⁴⁶ Absent requirements in the power that mandate oversight or preapproval of an agent's actions, agents are essentially on their own.⁴⁷ As a result, an agent can manage the financial affairs of the principal as the agent sees fit. Without any on-going oversight, who is to know if the agent

⁴⁵ Alison Barnes, *The Virtues of Corporate and Professional Guardians*, 31 STETSON L. REV. 941, 956 (2002).

⁴⁶ See Linda S. Whitton, *Durable Powers as an Alternative to Guardianship: Lessons We Have Learned*, 37 STETSON L. REV. 8 (2007).

⁴⁷ Nina A. Kohn, *Elder Empowerment as a Strategy for Curbing the Hidden Abuses of Durable Powers of Attorney*, 59 RUTGERS L. REV. 1, 18 (2006).

is dutifully carrying out his or her responsibilities? The agent is, to be sure, a fiduciary and held to the duty of loyalty and the obligation to avoid conflicts of interest and self-dealing, but how the agent is to make decisions is less clear.⁴⁸ Most states require the guardian to act in accord with substituted judgment, that is, to do what the incapacitated person would have done, although some states expect the agent to act in the best interests of the principal.⁴⁹ The latter presumably allows an agent to ignore the expressed wishes of the principal or the previous pattern of decisions by the principal if those decisions do not appear to be the best way to further the principal's financial interest. That has the advantage that an agent acting according to the best interest standard can ignore what the principal might have said or done in the period when the principal might have been suffering from a decline in capacity, though before the loss was sufficient to permit the agent to take control. Even states that insist upon the application of substituted judgment permit an agent to ignore what the principal would have wished if the agent believes that to do so would not be in the principal's best interest.⁵⁰ In the end, how an agent acts may not differ much whether the state standard is one of substituted judgment or best interest; the agent will do what the principal would have done unless it does not seem in the best interest of the principal to do so.

Of course, that is the point of a power of attorney – to create powers in the agent that are very similar to the legal rights of the principal. Unfortunately, that wide grant of authority makes it easy for an agent to perform poorly in managing an IRA even though carrying out his or her duties in a lawful manner.

The initial challenge for the agent is to intelligently invest the IRA assets. Probably, many agents do what is easiest, which is to do nothing and leave the assets invested as they found them. Maintaining the status quo is an attractive option. When faced with whether to act or do nothing, individuals usually prefer to stay the course rather than to make any changes because a lost opportunity is more easily overlooked and forgotten as compared with doing something that proves to be a mistake.⁵¹ The

⁴⁸ Karen E. Boxx, *The Durable Power of Attorney's Place in the Family of Fiduciary Relationships*, 36 GA. L. REV. 1, 27 (2001).

⁴⁹ See Carolyn L. Dessin, *Acting as Agent Under a Financial Durable Power of Attorney: An Unscripted Role*, 75 NEB. L. REV. 574 (1996).

⁵⁰ Whitton & Frolik, *supra* note 43, at 1499.

⁵¹ See Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 675 (1998).

preference for the status quo and the desire to avoid losses when faced with uncertain alternatives is well documented in psychological studies.⁵² So it is to be expected that an agent, unless quite confident in his or her investment skills, may choose to leave the asset allocation as is. Changing investments opens the agent to the possibility that the new investments will perform less well than the old investments would have if they had not been abandoned. That underperformance is a natural test to apply to the new investments. In contrast, the wisdom of not changing the investments is difficult to judge because it is unclear as to which possible alternative investment choice the status quo should be measured against. Suppose that when the agent took control from an incapacitated IRA owner, the IRA was invested forty percent in stocks and sixty percent in bonds. An agent, who maintained that asset allocation, could not be criticized because that is a common and defensible allocation of IRA assets. If, however, the agent changed the allocation to eighty percent bonds and twenty percent stocks, it is easy to measure the return of stocks over the next year and observe whether the retreat from stocks was a good decision; that is, the most profitable choice. If stocks had soared in value, it would seem that the agent made a mistake even though, to be fair, the wisdom of the decision to sell stocks and buy bonds should have been judged at the time of the stocks were sold and not in hindsight.

The maintenance of the status quo also fulfills the requirement of substituted judgment by doing what the principal apparently would have done. Doing so, however, assumes that the prior acts of the principal represented decisions made when the principal was fully in command of his or her mental facilities. In many instances, however, that will not be the case. The principal's mental incapacity might have been the result of a swift and dramatic debilitating illness, but it is far more likely that the principal's capacity was a gradual decline and that he or she continued to manage the IRA while suffering from diminished capacity. And during that period of time, the principal may have made investment decisions that did not represent the "true" intent of the principal; that is, the principal at full mental capacity. Obviously, no agent should feel bound by substituted judgment to carry out decisions made by a principal, who suffered from reduced capacity. Given that the agent cannot know when the principal began to lose capacity, and so which past decisions reflect a reduced level

⁵² See, e.g., Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 *ECONOMETRICA* 263 (1979).

of incapacity, an agent should be hesitant to apply substituted judgment to the management of an IRA.

An agent, if not bound by substituted judgment, necessarily must apply the best interest test and manage the IRA in a manner that best promotes the principal's interests, presumably both financial and personal. That dictate, however, presents a number of difficulties for a conscientious agent.

The agent must manage the IRA in a manner that will maximize returns commensurate with an acceptable level of risk. While maintaining a proper return/risk balance is difficult for any investor, an agent managing an IRA, faces the additional obligation of serving the best interest of the principal, which is an almost impossible task because there is no simple metric that tells the agent whether any particular investment strategy meets that obligation. If the agent errs on the side of lower risk, the investment return will suffer, and that in turn will either mean smaller distributions in the future, and so a diminished quality of life for the principal, or an IRA of a lesser value to pass on to the principal's heirs. Of course, the agent has no way of knowing whether the principal is better served by lower investment returns but less risk, or whether the principal would be better off if the agent took greater risks and so achieved greater investment returns. Taking greater risks could either mean greater distributions or a larger IRA to pass on to heirs, but could also mean a loss of capital and so lower returns in the future.

Not only do investment decisions present difficulties for an agent; so do distributions. An agent, when making IRA distributions beyond those mandated by the minimum distribution rules, must look to the quality of life of the principal with an eye towards balancing present and future needs. An increase in distributions today may result in smaller distributions in the future, and also dictates taking greater investment risks in order to support continued large distributions in the future. The agent, who must make decisions in an ever-changing investment climate, must also make distributions with due consideration of the possibility that the principal's financial needs may be increasing as his or her physical and mental condition declines.

It should be apparent, then, that even a dedicated, conscientious agent will find it difficult to manage an IRA. Many individuals, no matter how well intentioned, will not be up to the task. They will lack the investment acumen and sophistication required to successfully handle

investments of a fund from which annual distributions are being made.⁵³ They will also be unable to determine the appropriate amount of distributions in light of the tension between the current and future needs of the principal. The interplay of investment choices, distribution decisions, a fluid investment landscape, and the changing needs of a physically and mentally declining principal will be beyond the ability of most agents.

The inability of the typical agent to effectively manage an IRA is also a result of who the principal is likely to appoint as agent. Usually, in order of priority, principals name their spouse, next an adult child, and finally a more distant relation. None of these individuals are selected because they are financially sophisticated or skilled at managing an IRA; rather, they are named because they are someone the principal trusts and who are willing to serve as an agent. Overwhelmingly, principals name spouses and children as agents, in part because the principal does not realize how difficult it can be for an agent to manage the principal's financial affairs, particularly if the principal owns a rollover IRA.

Additionally, even if the individual who was named agent made sense at the time the power of attorney was executed, that appointment might not be a wise choice by the time the agent actually takes over for the incapacitated principal. For example, at age seventy, the IRA owner named his sixty-nine-year-old wife as agent, but when he became incapacitated at age eighty-six, she was eighty-five and beginning to suffer some mild loss of memory. Will she be mentally sharp enough in the coming years to successfully manage his IRA account? What of the seventy-five-year-old woman who named her fifty-three-year-old daughter as agent, but did not become incapacitated until age ninety when her daughter was sixty-eight and undergoing intensive treatment for lung cancer? Is the daughter really going to be capable of handling her mother's IRA? Or consider a seventy-five-year-old man who names his twenty-five-year-old nephew as his agent. Ten years later, when the principal needs his agent to take over the principal's finances, the now thirty-five-year-old nephew has just filed for bankruptcy after he lost his job, had his house foreclosed and is in the midst of a bitter divorce, not exactly the person the eighty-five-year-old principal would now choose to act as his agent.

⁵³ Financial literacy varies considerably. Some agents may be quite capable; others much less so. One study found that individuals with less education and less wealth have a lower level of financial sophistication and are prone to making more investment errors. Laurent E. Calvet et al., *Measuring the Financial Sophistication of Households*, 99 AM. ECON. REV. (PAPERS & PROC.) 393, 397-98 (2009).

Even if the agent is not suffering from health or financial problems, there is no reason to suppose that most agents will be effective at managing an IRA. When managing an IRA, an agent has incentives and motivations that are not the same as those of the principal, which result in classic “agency costs.”⁵⁴ Unlike the principal, who has a financial stake in the management of the IRA, the agent does not. If the agent is paid, it will be by the hour with little regard to the quality of the agent’s performance. The many agents who are not compensated are motivated by love, concern, and a sense of responsibility; none of which may translate into effective management of the principal’s IRA. Agents may in fact be less capable because they are not dealing with their own money and the quality of their own life is not affected by their decisions. Although the agent may want to make decisions that best promote the interest of the principal, it is unlikely that an agent will devote as much time and energy in managing the IRA as would the principal. That lack of self-interest alone is likely enough to mean less effective management of the IRA by the agent, even assuming the agent has skills comparable to the principal.

In some cases, third parties may bring pressure to bear on the agent. Those who are the beneficiaries of the IRA after the principal’s death may urge greater or lesser risk taking in the IRA investments as a way of protecting their expected future inheritance. Or they may advise the agent to minimize distributions in order to increase their inheritance. For example, if the principal needs daily assistance, the question may arise as to whether to purchase daily attendant care in the principal’s home or elect more economical housing in an assisted living facility. Whether the agent is willing to pay for expensive personal care may depend on the agent’s relation to the principal. An agent, who is the spouse of the principal, may choose to pay for personal care, while an adult child, with an eye to his or her inheritance, may think assisted living is a more sensible choice.

If the agent stands to inherit the IRA, the conflict of interest is obvious and real; yet the selection of an adult child as agent is understandable, though still unfortunate. How an agent responds to a conflict of interest may depend on the agent’s relative financial status and how much the agent is looking forward to inheriting a well-funded IRA.

⁵⁴ See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308–10 (1976). For an analysis of why a trustee’s relation to a settlor exhibits agency costs, see Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 624 (2004).

The agent is a fiduciary and so should resolve any conflict in favor of the principal or resign as agent. In reality, however, an agent's decisions as to the management of an IRA are likely to be within the zone of the agent's discretion and so are not obvious violations of the agent's fiduciary duty. Even if the agent fails to meet his or her fiduciary obligations, absent a rather obvious transgression and someone who is willing to object, the agent will not be called to account.

Beyond the honest but marginally competent agent are those who misuse, abuse or steal the principal's assets. In the past, agents have made inappropriate gifts to third parties, made inappropriate gifts to themselves, made gifts to charities not favored by the principal, defeated estate plans by creating joint accounts with survivorship interests, changed beneficiaries named in life insurance contracts, revoked trusts, engaged in self-dealing, and used their powers to benefit their spouses, friends or relatives. In short, agents routinely violate their fiduciary obligations and use their authority to advance their own interests at the expense of the principal.⁵⁵

If the agent misuses or wastes the assets in the IRA, the elderly IRA owner will not only be incapacitated but may also be impoverished. Of course, an elderly IRA owner will try to select a trustworthy person to act as agent, and most probably succeed in doing so, but not all will make the right choice.

An aging owner of a retirement IRA who is losing the ability to manage it faces the alternative of accepting guardianship or appointing an agent under a durable power of attorney, neither of which assures proper management of the IRA. This is the world that our nation's retirement system has created for its elderly. The reliance on 401(k) plans has been rightly criticized for leaving retirees with inadequate savings for their retirement. Many have attacked 401(k) accounts for putting the investment risk on employees who in general are not up to the burden.⁵⁶ But even those employees who arrive at retirement having adequately managed their account and have an account with enough money to create a financially secure retirement must still navigate the perilous years of their retirement.

⁵⁵ See generally Jennifer L. Rhein, *No One In Charge: Durable Powers of Attorney and the Failure to Protect Incapacitated Persons*, 17 ELDER L.J. 165 (2009) (describing how agents acting under durable powers of attorney agreements can exploit incapacitated principals).

⁵⁶ Debra A. Davis, *Do-It-Yourself Retirement: Allowing Employees to Direct the Investment of Their Retirement Savings*, 8 U. PA. J. LAB. & EMP. L. 353, 365 (2005).

Like a modern Odysseus, they must successfully navigate a long and difficult voyage.

VII. ANNUITIES

Because of the difficulties of post-retirement management of a rollover IRA, some hope to recreate the advantages of the defined benefit pension by encouraging retirees to convert some or all of their IRA into an immediate pay, lifetime annuity.⁵⁷ Doing so would address the two significant risks created for retirees - financial management and longevity.

A. RECREATING THE ADVANTAGES OF A DEFINED BENEFIT PLAN

The owner of an IRA can capture many of the advantages of the pensions offered by defined benefit plans by converting some or all of the account into an annuity. Merely investing half of the account can dramatically increase the probability that the retiree will not outlive the IRA.⁵⁸ The purchase of a lifetime annuity eliminates the need to manage the investment of those funds, determining which assets should be used to fund distributions, and the fear of zeroing out the fund prior to death. At present, only twenty percent of defined contribution plans offer retirees the option of converting their accounts into an annuity, and only about ten percent of the employees of those plans choose the annuity option. Even if an annuity is available as part of the 401(k) plan, retirees typically prefer a lump-sum distribution to an annuity.⁵⁹ Interestingly, retirees who participate in defined benefit plans often have the option of accepting a pension, which can be thought of as an annuity, or accepting a lump-sum distribution. Although some do elect to take the lump sum, the rate of those who choose the pension do so at a much higher rate than those with defined contribution accounts elect to convert them into an annuity. Apparently, both those expecting pensions and those anticipating the

⁵⁷ See generally Frolik, *supra* note 7 (arguing that federally guaranteed annuities for retirees paid for by 401(k) accounts would provide a more secure method of extending retirement savings).

⁵⁸ Walter Updegrave, *Make Your Dough Last and Last...and Last*, 38 MONEY 92, 94 (Oct. 2009).

⁵⁹ Steven D. Cohen, Note, *Autoenrollment and Annuitization: Enabling 401(k) "DB-ation,"* 5 N.Y.U. J.L. & BUS. 281, 317 (2009).

receipt of a lump sum prefer to stay with the status quo.⁶⁰ For most retirees, exchanging a lifetime of accumulated retirement investment, a very large figure, for periodic annuity benefits, a much smaller figure, is not an appealing tradeoff.⁶¹

A variety of structural reforms are needed to encourage the purchase of annuities. No one reform is going to drastically change the current retiree reluctance to purchase annuities, but in combination, they could begin to change their attitudes. What is needed is a sense by retirees that annuitizing at least part of their rollover IRA is presumptively the intelligent thing to do. We need to reach the point where a retiree feels the need to justify not buying an annuity rather than retirees believing, as they do today, that keeping a lump sum distribution in an IRA is the more sensible approach.

Perhaps many retirees reject annuities because they think of an annuity as an investment rather than the insurance product that it is.⁶² The purchase of an immediate pay, lifetime annuity is the purchase of a stream of income, to be sure, but it is better understood as a “guarantee” of income for life.⁶³ The value of the product is not just the benefits that it pays, but more importantly the assurance of a lifetime of income. An annuity provides a relatively risk-free means of converting capital – the cost of the annuity – into disposable income without fear of exhausting the fund. The insurance value of the annuity is fulfilled no matter when the annuitant dies and the benefit payments cease. Even if an annuitant dies before his or her actuarially projected date of death, he or she does not “lose.” Someone who buys fire insurance has not “lost” if there is no fire and no compensation is paid, because it is avoidance of the risk of loss that was the motivation for the purchase. In the case of an annuity, it is the guarantee of a lifetime of income that justifies its acquisition.

⁶⁰ Shlomo Benartzi et al., *Annuitization Puzzles*, 25 J. ECON. PERSP. 143, 156 (2011).

⁶¹ Robert Gazzale et al., *Do Default and Longevity Annuities Improve Annuity Take-Up Rates? Results from an Experiment*, 11 AARP PUB. POL’Y INST. 10, 10–11 (Oct. 2012).

⁶² See Benartzi et al., *supra* note 60, at 156.

⁶³ The “guarantee” of course is only as good as the financial strength of the seller of the annuity. Those who purchase annuities, however, assume that the seller will in fact pay the annuity as promised. It is difficult to believe that any annuitant who had doubts about the certainty of payment would buy an annuity.

Unfortunately, too often those who buy annuities think that they must outlive their expected date of death to avoid “losing” the bet with the seller of the annuity.⁶⁴ To overcome the perceived “gamble” of buying an annuity, an agent, who is selling the annuity, points out that the annuity protects buyers who outlive their life expectancy from outliving their savings. What the agent may not realize is that most individuals underestimate how long they will live. The agent who points out to sixty-five-year-olds that if they live longer than their twenty year life expectancy, they will reap a windfall (actually merely a modestly higher rate of return on the investment, i.e. the cost of the annuity) fails to realize that many potential buyers do not expect to live for another twenty years and so fear that they will never realize that windfall. Moreover, because of the tendency of individuals to hyper-discount future income, even if the potential buyers expect to live long enough to get the windfall, they greatly undervalue it. The combination of underestimating the likelihood of living past their projected life expectancy and undervaluing the payoff if they do, naturally causes many to avoid annuities, which they perceive as very likely resulting in a large “loss” (the cost of the annuity) and a smaller chance of a small gain (the payments continuing on past their life expectancy). Given that many see an annuity as being more likely to result in a perceived, if not a real, loss, and given that most individuals fear losses more than they appreciate gains, it is small wonder that annuities are not attractive to most retirees.⁶⁵

For many, annuities are also unattractive because they limit the ability to leave a financial legacy. They look at the total value of an IRA, and underestimating how long they will live, assume that they will be able to leave most, if not all of that IRA, to their children.⁶⁶ They cannot imagine giving up that legacy by purchasing an annuity regardless of the advantages of doing so. To a remarkable degree, the elderly are willing to

⁶⁴ Most who purchase annuities try to reduce the risk of an early death resulting in a “loss” by purchasing an annuity with a term certain payout period. For example, the annuity might guarantee a minimum payout of ten years. Hu & Scott, *supra* note 29, at 77.

⁶⁵ Jeffery R. Brown et al., *Why Don't People Insure Late-Life Consumption? A Framing Explanation of the Under Annuity Puzzle*, 98 AM. ECON. REV. (PAPERS & PROC.) 304, 304–05 (2008).

⁶⁶ This description holds true whether the IRA owner is single or married. If the latter, then the expectation is that the IRA will be intact at the death of the second to die of the spouses and the IRA owner.

forego consumption in order to preserve their assets so that they can pass them on, usually to their children. While the children and their financial advisors may urge the older person to spend more on themselves, to “live a little,” that advice is often not heeded because many elderly are determined to preserve their capital for their heirs.

Even financially sophisticated retirees who understand the advantages of annuities may not buy them for fear that the seller of the annuity might find itself unable to pay the annuity. Other potential purchasers may be willing to bear the modest risk of possible nonpayment, but may be reluctant to buy annuities because of the fear of rising interest rates. A reasonable fear of the annuity purchaser is that interest rates (as well as investment returns in general) will rise after the annuity has been purchased, leaving the annuitant locked into an annuity whose payments are low because they are based on projected lower interest rates.⁶⁷ Similarly, because sellers of annuities also invest in stocks, a general rise in the stock market after the purchase of an annuity may mean that the purchaser, by waiting a few months and realizing more on the sale of his or her stocks, could have bought a larger annuity.

The possible rise in annuity payment rates is one reason some advocate buying more than one annuity and spacing out the purchases over a few years. Known as “laddering,” the strategy may backfire if future annuity payments decline because of lower interest rates or a decline in the value of stocks, but it does have the advantage of averaging annuity payments over several years and so avoiding extremely low payments, albeit at the potential cost of not locking in higher payments. Laddering also protects against investing a significant portion of assets into a single lifetime annuity that does not have a minimum payout period, and dying soon thereafter. By laddering, or deferring the investment of some funds targeted for the purchase of an annuity, the individual may die before having invested all of the value of the IRA in annuities.

To overcome potential purchasers’ fears that they may die early in the payout period, annuities are often sold with minimum payout periods, with 10 years being common. Of course, a minimum payout period lowers the annual payout, but for many purchasers the trade-off is worth it. Other annuities guarantee a back-pay equal to the initial purchase price. If the

⁶⁷ The seller of the annuity will invest the purchase price. The benefits paid by the annuity will vary based upon the projected investment return anticipated by the seller. If interest rates are low, the seller has to assume a lower rate of investment return.

annuitant dies before that occurs, the annuity continues to pay until it has paid back the purchase price, but of course at the cost of a lower annual payment. Simply put, the more an annuity varies from the “pure product” of a lifetime guarantee without any minimum payment guaranty, the lower the annual payment but the more it appeals to purchasers who are not comfortable with the prospect of dying long before their projected life expectancy.

For those apprehensive about whether the seller of the annuity will be financially secure enough to pay the annuity, one solution is to buy smaller annuities from several annuity sellers, thereby spreading the risk. If one seller should fail, only a portion of the total annuity payments would be lost.

Another possibility is to purchase a deferred annuity with a fixed payout.⁶⁸ For example, a 65-year-old buys an annuity for \$X that will pay \$Y per year for life, but the initial payment will not begin for 10 years (when the purchaser is age 75). Depending on the annuity, it may pay back some, or all, of the purchase price if the annuitant dies before reaching age seventy-five. The advantage to the annuitant is that for \$X purchase price, the annuitant realizes a significantly larger annual payment than by paying the same amount for an immediate pay annuity.⁶⁹ During the intervening ten years, the annuitant can draw down his or her savings knowing that, at age seventy-five, a new stream of income will appear. Some advocate dividing the retirement savings that the retiree expects to spend during retirement – not including savings that are being held back to pass on to heirs – into two equal parts: buying an annuity to begin at age 80, and then spending the other half during the years leading up to age 80. The delay in the start of the annuity will result in a higher annual payment, and the certainty of the forthcoming income permits the annuitant to “self-annuitize” the other half of the savings over the years leading up to age 80.

⁶⁸ Jonathan Barry Forman, *Optimal Distribution Rules for Defined Contribution Plans: What Can the United States and Australia Learn from Other Countries?*, in N.Y.U. REV. OF EMP. BEN. & EXECUTIVE COMPENSATION 3-1, 3-28 (Alvin D. Lurie ed., 2012).

⁶⁹ In February of 2012, the purchase of a deferred annuity for \$100,000 by a sixty-five-year-old male with the first payment to begin at age seventy-five paid about \$11,650 a year. If the annuity was deferred until age eighty-five, the yearly payment was about \$25,450 per year. Calculations are taken from *id.* at 3–29.

B. POSSIBLE REFORMS TO ENCOURAGE THE PURCHASE OF ANNUITIES

The first step is to mandate that all 401(k) plans offer an annuity option and require all rollover IRAs to permit the owner to purchase an annuity without recognition of immediate income.⁷⁰ As a practical matter, the use of IRA funds to purchase an annuity without being taxed on the purchase price should be time limited, perhaps to the first year after the rollover into the IRA. Of course, the entire amount of the annuity is be taxed as ordinary income; the exclusion ratio provided in section seventy-two of the IRC does not apply to annuities purchased with funds that were never subject to the income tax.

Unless the government does something to encourage the use of annuities by IRA owners, the financial security of many retirees will be severely compromised in the years to come. We can expect unacceptable rates of elderly poverty and increasing elderly financial exploitation and abuse. To overcome the reluctance of retirees to purchase annuities, the federal government could create, sell, and likely subsidize new forms of annuities for retirees who have a rollover IRA.⁷¹ No one would be required to purchase an annuity from the government, but if the annuities were attractive enough, many retirees might be inclined to purchase them.

A public entity that sold annuities (fully backed by the federal government) would overcome retiree fears about the financial solvency of the issuer of the annuity. So that government would not compete generally with issuers of annuities, the entity should be limited to selling annuities to retirees who pay for it with funds from their 401(k) or a rollover IRA. Such an entity should be able to sell an attractively priced annuity in part because of savings in the form of lower administrative costs, the lack of the need to advertise, and savings from not paying commissions to sellers of the annuities, as well as not being burdened with the need to create a profit.

To meet the concern of annuity purchasers that they might be buying the annuity when interest rates were too low, the annuities could be tied to a rolling, five-year interest rate based on the interest rate of U.S. Treasury notes. The pension paid to those who participate in a defined benefit plan is not dependent on the prevailing interest rates at the time of the employee's retirement. Similarly, employees who participate in 401(k) plans should have the opportunity to convert their 401(k) accounts into a

⁷⁰ A more radical solution would be to require retirees with 401(k) accounts to purchase annuities. *See id.* at 3–32.

⁷¹ Frolik, *supra* note 7, at 278.

stream of income that is not wholly dependent on the rate of interest prevailing at the time of their retirement. Perhaps some form of post-purchase protection in the form of a higher payout if interest rates rise appreciably might be a solution. The annuities might also offer modest inflation protection. The monthly payout could be increased by a certain percentage in the event that the increase in the consumer price index exceeded a predetermined trigger level. While not offering the complete inflation protection enjoyed by Social Security recipients, whose annual benefit rises with inflation, the partial protection would encourage the purchase of annuities by those who are wary of locking their capital into a fixed income investment.⁷²

Of course, the more protection offered by the annuities, the more they would cost unless some or all of those protections were subsidized by the government. The justification for a subsidy is the public interest in assisting retirees who participated in defined contribution plans to use, enjoy and create lifetime, assured streams of income. For years the nation has promoted employer provided retirement plans by providing generous deferral of income taxes on 401(k) accounts. Modestly extending that subsidy to the post-employment years would not seem excessive.

VIII. CONCLUSION

The assumption that retirees can successfully manage their IRAs during their declining years is a folly. Why any society would willfully create a retirement system that relies on the financial acumen of millions of aging individuals can only be explained as the triumph of hope over common sense and reality. Unless we relieve retirees of the burden of the responsibility for their retirement assets, we can expect growing poverty among the elderly as they mismanage and spend down their retirement funds.

It is time to admit that what most retirees need is a stream of income. Our nation's retirees need and deserve the security of having a check arrive every month that does not depend upon their skill at managing an IRA during their declining years.

⁷² *See id.* at 320-30 (discussing ways the government could encourage the purchase of annuities).