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THE SOCIAL COSTS OF CHOICE, FREE MARKET IDEOLOGY AND THE EMPIRICAL CONSEQUENCES OF THE 401(K) PLAN LARGE MENU DEFENSE

MERCER BULLARD*

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This article explores the recent "hidden-fee" litigation trend that has consumed the 401(k) world and how recent decisions by these courts will likely result in reduced wealth for workers. The author challenges the "large menu defense" espoused by the Third, Seventh and Eight Circuit Courts of Appeals as not fitting within the intent of ERISA's "safe harbor." In addition, the author questions the logic of these decisions by suggesting that courts are evaluating the employers' legal responsibilities using free-market ideology rather than the fiduciary duties prescribed by ERISA and questions the belief that "large menu" pension benefit plans are wealth-maximizing.

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In October 2008, just after the peak of the financial crisis, former Federal Reserve Board Chairman, Alan Greenspan, testified: "I do have an ideology. My judgment is that free, competitive markets are by far the unrivaled way to organize economies. We've tried regulation. None meaningfully worked."[1] In fact, regulation has often worked and worked well, as illustrated by reforms in pension plan regulation. Investors often do behave like the rational actors on which the efficacy of free, competitive markets is based, especially when they are deciding whether to participate in their employers' 401(k) plans. Many employees do not participate, even when their employers offer to match employees' contributions. In 2006, Congress amended the Employee Retirement Security Income Act of 1974 (ERISA) to permit employers to automatically enroll their employees in the company's 401(k) plan. As a result, plan participation rates have risen

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[1] *Financial Crisis and the Role of Government Regulators: Hearing Before the Comm. on Oversight and Gov't Reform*, 110th Cong. 46 (2008). As the financial crisis unfolded around him, however, Chairman Greenspan acknowledged that he had become aware of a "flaw" in this ideology. *Id.*

dramatically. This regulatory "nudge" has increased the wealth of millions of Americans.

In a series of recent decisions, however, federal courts have taken positions that effectively *reduce* employee participation rates in 401(k) plans. They have exalted free market ideology in derogation of express regulatory mandates on the assumption that substituting their economic assumptions for legal requirements will maximize the wealth of 401(k) participants. Yet their faith in free markets is not grounded in any empirical foundation. In fact, their economic theories are directly contradicted by the overwhelming weight of empirical research, which shows that the effect of their decisions will reduce workers' wealth rather than increase it. This collision of judicial free-market ideology and financial reality, the subject of this article, is costing American workers billions of dollars in lost pension benefits every year.

Over the last decade, a slew of lawsuits have consumed the 401(k) world, making a substantial amount of new case law and sending employers in search of experts to find ways to protect them from liability. This so-called "hidden-fee litigation" generally involves claims that employers and other pension benefit plan fiduciaries violated ERISA's "prudent man" rule by selecting investment options that charge excessive fees and hide information about fees from participants. Some courts have dismissed claims against employers that offer a large number of investment options in their plans on the ground that, regardless of whether the employer acted imprudently, the legal cause of any resulting loss was the participant's choice of the option(s) in which to invest. These courts consider large 401(k) menus to offer a kind of marketplace that trumps employers' fiduciary obligations. This "large menu defense" creates an incentive for employers to increase the number of options in their 401(k) plans in order to minimize their ERISA liability risk.

These courts have ignored ERISA's express imposition of liability on plan fiduciaries for failing to exercise due care in choosing plan investment options. Section 404(a) of the Act establishes a "prudent man" standard that requires, among other things, that plan sponsors choose investment options with due care. Section 404(c) provides a safe harbor ("404(c)" or "control" safe harbor) from Section 404(a) liability to the extent that a self-directed plan permits a participant "to exercise control over the assets in his account." Under Section 404(c)'s authority, the Department of Labor (DOL) has adopted rules providing that a participant may be deemed to have exercised control if, among other things, the plan offers a "broad range of investment alternatives" that enables participants

to create portfolios with risk-return characteristics that are appropriate for the participant.

Some courts have deemed participants to have exercised control under the 404(c) safe harbor if a plan's range of options is so broad that, in the court's opinion, it approximates the range of options that would be available in a free market.[2] The availability of a large range of options thereby abrogates employer responsibility for imprudently selecting investment options. The large menu defense effectively substitutes judicial economic theories for statutory fiduciary duties, based primarily on the courts' ideological view, like Chairman Greenspan's, that participants' choices should be regulated by free market principles rather than under ERISA's fiduciary duties. The courts' view, consistent with widely accepted rational choice theory, is that offering the largest range of choices will maximize workers' wealth. Indeed, they view increasing choice, in and of itself, as a central purpose of ERISA.

This *de facto* judicial nullification of ERISA's prudent man rule would not be of such concern if the courts were correct that larger menus create wealth for workers. In that case, employers that increased the number of options in their plans in order to reduce their ERISA liability risk would also maximize the social benefits of 401(k) plans. However, empirical research shows that larger menus are *inversely* correlated with workers' wealth. Large 401(k) menus result in lower participation rates, overly conservative allocations, inferior investment options and other adverse effects that, collectively, cost workers billions of dollars every year. Notwithstanding the courts' views on rational choice theory, "a fully informed and fully rational investor would prefer a smaller menu."[3]

Section I of this article describes the legal framework for employers' liability under ERISA in connection with the selection of plan investment options. Section II discusses the large menu defense adopted by courts that have dismissed fiduciary claims against employers that were alleged to have selected options impudently. The courts' free-market rationale for the large menu defense is described in Section III, and Section IV sets forth the empirical research on the wealth-reducing effects of large menus in 401(k) plans. Section V concludes.

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[2] *See infra* Section II.

[3] David Goldreich & Hanna Hałaburda, *When Smaller Menus Are Better: Variability in Menu-Setting Ability* 4 (Harvard Bus. Sch., Working Paper No. 11-086, 2011), *available at* http://www.hbs.edu/faculty/Publication%20Files/11-086.pdf.

I. BACKGROUND

ERISA generally applies to "employee benefit plans," which are defined to include employee welfare benefit plans and employee pension benefit plans.[4] This article is concerned with pension benefit plans, such as 401(k) plans, which are defined as funds or programs maintained by an employer that "(i) provide retirement income to employees, or (ii) result in a deferral of income by employees for periods extending to the termination of covered employment or beyond."[5] If an employer offers a pension benefit plan, ERISA requires that it identify at least one "named" fiduciary who is responsible for the administration of the plan. For example, the plan trustee is a named plan fiduciary. A person can also become a fiduciary by exercising discretion over plan assets or providing advice for a fee to the plan. A plan fiduciary can designate another person as a fiduciary and thereby shift their fiduciary responsibilities to that person.

A plan fiduciary is subject to two primary sets of duties under ERISA. First, Section 404(a) of ERISA subjects fiduciaries to a prudent man standard of care. They must act with the "care, skill, prudence, and diligence" that a "prudent man acting in a like capacity" would use in selecting investment options and diversifying the plan's investments "so as to minimize the risk of large losses." Section 404(a) also imposes a duty of loyalty. Fiduciaries must discharge their duties "solely in the interests of the participants and beneficiaries and for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan."

Second, ERISA prohibits plan fiduciaries from engaging in a broad range of transactions with the plan. Specifically, Section 406(b) of ERISA prohibits fiduciaries from dealing with plan assets in the fiduciary's "own interest," acting on behalf of an adverse party in a transaction, or receiving any consideration from any party dealing with the plan in connection with a transaction involving the assets of the plan. Plan participants have a private right of action against fiduciaries to recover losses resulting from a breach of their obligations under ERISA.[6] The breadth of Sections 404(a) and 406(b), coupled with a private right of action for damages, presents employers with significant liability risk.

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[4] 29 U.S.C. § 1003(a) (2006).
[5] 29 U.S.C. § 1002(2)(A) (2006).
[6] 29 U.S.C. § 1109(a) (2006).

To mitigate this risk, ERISA provides a number of statutory safe harbors for fiduciaries, which are supplemented by prohibited transaction exemptions and interpretive safe harbors promulgated by the DOL.[7] Plan fiduciaries generally attempt to limit their liability by conforming their conduct to these safe harbors and exemptions. One of the most commonly relied-upon safe harbors is provided by Section 404(c)(1)(A)(ii) ("404(c)" or "control" safe harbor), which insulates fiduciaries from liability for losses resulting "from the participant's or beneficiary's exercise of control" over the assets in his account.

The DOL has set forth a number of conditions on the availability of the 404(c) safe harbor. These conditions include offering a diversified set of investment options and providing participants with sufficient information to evaluate them. A participant has "exercised control" if, among other things, he "has an opportunity to choose, from a broad range of investment alternatives, the manner in which some or all of the assets in his account are invested."[8] A "broad range of investment alternatives" has been provided if the participant has an opportunity to: (1) materially affect the potential return and degree of risk of the account; (2) diversify so as to minimize the risk of large losses; and (3) choose from at least three diversified investment options.[9] These investment options must have materially different risk and return characteristics such that they can be combined in a portfolio with aggregate risk-return characteristics that are

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[7] *See*, *e.g.*, 29 U.S.C. § 1108(b)(19) (2006) (exemption from Section 406(b)(2) for certain cross transactions); Class Exemption To Permit Certain Loans of Securities by Employee Benefit Plans, 71 Fed. Reg. 63,786 (Feb. 2, 2006) (exemption from Section 406(b)(1) with respect to securities lending activities); Class Exemption for Cross-Trades of Securities by Index and Model-Driven Funds, 67 Fed. Reg. 6614 (Feb. 12, 2002) (exemption from 406(b)(2) with respect to certain cross transactions involving passively managed funds); Class Exemption for Securities Transactions Involving Employee Benefit Plans and Broker-Dealers, 51 Fed. Reg. 41,686 (Nov. 18, 1986) (exemption from Section 406(b) to fiduciaries that execute transactions on behalf of a plan); Class Exemption for Certain Transactions Between Investment Companies and Employee Benefit Plans, 42 Fed. Reg. 18,732 (Apr. 8, 1977) (exemption for fiduciary when acting in capacity of investment adviser to mutual fund in which plan assets are invested); *see also* 15 U.S.C. § 78bb(e) (2012) (no breach of fiduciary duty solely by reason of receiving soft dollar benefits limited to brokerage and research services).

[8] 29 C.F.R. § 2550.404c–1(b)(1)(ii) (2013).

[9] 29 C.F.R. §2550.404c-1(b)(iii) (2013).

within the range that is appropriate for the participant and that tend to minimize the risk of the overall portfolio.

Over the last decade, a series of lawsuits against plan fiduciaries has challenged the edifice of safe harbors and exemptions on which they have come to depend. The plaintiffs in these lawsuits – lawsuits which are often referred to as "hidden fee litigation" – have generally claimed that plan fiduciaries violated their duties by offering investment options that charge excessive and/or hidden fees. Plaintiffs allege that fees were hidden because they were not disclosed to participants and excessive because the plans invested in retail classes of fund shares that made side payments to plan services providers (known as "revenue sharing" payments) rather than in less expensive institutional classes of shares. The hidden fee litigation has generated dozens of judicial decisions addressing a broad array of issues under ERISA.

This article focuses on the role that the size of a plan's menu of investment options has played in the application of the 404(c) safe harbor and the disposition of these cases. As discussed immediately below, a number of courts have found that offering a large menu of investment options supports a finding that participants exercised control for purposes of the safe harbor. These courts have expressly rejected the DOL's "paternalistic" view that plan fiduciaries are responsible for any options that have been imprudently included in the mix even when participants have been able to choose from a large number of alternatives.

II. THE LARGE MENU DEFENSE

In one set of hidden fee cases, courts have held that offering a large number of investment options can protect an ERISA fiduciary from liability, while offering a small number may increase a fiduciary's legal exposure. The leading case for the "large menu defense" is *Hecker v. Deere & Co.*, in which the Seventh Circuit found that Deere's offering of thousands of investment options in its 401(k) helped establish that, even if some options had been imprudently selected, Deere's imprudence could not have been a legal cause of the plaintiffs' losses.[10] The court found that the large menu of investment options effectively placed the participant in control of his investment decisions, thereby relieving Deere of potential liability.

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[10] Hecker v. Deere & Co., 556 F.3d 575, 584–87 (7th Cir. 2009).

In *Hecker*, a class of participants in Deere's 401(k) plan sued Deere for breaching its fiduciary duty to the plan by, among other things, selecting investment options that charged excessive, hidden fees. The plaintiffs generally alleged that the fees were excessive because: (1) the administrator of the plan was compensated indirectly through revenue sharing payments by the investment options in which the plans invested rather than directly from the plans themselves; and (2) those fees were not reasonable in view of the services provided. They argued that Deere violated its fiduciary duty by failing to exercise proper care in evaluating and selecting the investment options.

The district court granted the defendants' motion to dismiss on the ground that Deere was protected by ERISA's 404(c) safe harbor. As noted above, the 404(c) safe harbor insulates fiduciaries from liability for any loss that "results from the participant's or beneficiary's exercise of control" over the assets in his account. The court found that Deere had satisfied the 404(c) safe harbor by offering a large number of investment options.[11] The plan offered twenty-three Fidelity mutual funds, two funds managed by Fidelity Trust, an employer stock fund, and an investment window that provided access to more than 2,500 funds managed by different companies.[12] The district court found that, in light of the large number of investment options and the impossibility of every one of them having an excessive expense ratio, "[t]he only possible conclusion is that to the extent participants incurred excessive expenses, those losses were the result of participants exercising control over their investments within the meaning of the safe harbor provision."[13] Whether Deere exercised due care in selecting the investment options did not matter to the court: "[a]ssuming . . . that defendants failed to satisfy their fiduciary obligation to consider expenses when selecting mutual fund investment options, they are nevertheless insulated from liability by the safe harbor provision because of the nature and breadth of funds made available to participants under the plans."[14]

On appeal, the Seventh Circuit agreed that Deere had "include[d] a sufficient range of options so that the participants have control over the risk

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[11] Although the 404(c) safe harbor is an affirmative defense that normally would not be available at the pleading stage, the court found that the plaintiffs had opened the door to defense by anticipating the safe harbor in their complaint.

[12] 556 F.3d at 578.

[13] Hecker v. Deere & Co., 496 F. Supp. 2d 967, 976 (W.D. Wis. 2007).

[14] *Id.* at 976.

of loss."[15] Assuming that Deere had a duty to "furnish an acceptable array of investment vehicles," the court found that the "wide range of expense ratios among the 20 Fidelity mutual funds and the 2,500 other funds available through [the plan]" satisfied this duty.[16] Any losses experienced by participants were "attributable to their individual choices. Given the numerous investment options, varied in type and fee, neither Deere nor Fidelity . . . can be held responsible for those choices."[17]

The Third Circuit adopted *Hecker's* large menu defense in *Renfro v. Unisys Corp.*[18] In *Renfro*, a class of participants in Unisys Corporation's 401(k) plan sued Unisys for breach of fiduciary duty under ERISA. As in *Hecker,* the plaintiffs claimed that defendants' selection of investment options was imprudent because the options charged revenue sharing payments that were hidden and excessive. The plan, one of the largest one percent of 401(k) plans in the U.S., held approximately $2 billion in more than seventy different investment options. Nearly $1.9 billion of that amount was held in "Fidelity-branded" retail mutual funds that plaintiffs alleged had charged excessive fees.

The district court granted Unisys's motion to dismiss on the ground that "no rational trier of fact could find, on the basis of the facts alleged in the operative complaint, that the Unisys Defendants breached an ERISA fiduciary duty by offering this particular array of investment vehicles."[19] The court, citing *Hecker* in support, found that Unisys could not be held liable for the selection of investments because it had offered a broad range of investment alternatives, regardless of whether it had placed any inappropriate investment options in the plan.[20] The participants "could choose from among the investment options to create a portfolio tailored to meet their investment objectives,"[21] which insulated Unisys from liability. The court considered Unisys's large menu to support both a Rule 12(b)(6)

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[15] 556 F.3d at 589.

[16] *Id.* at 586.

[17] *Id.* at 590.

[18] Renfro v. Unisys Corp., 671 F.3d 314 (3d Cir. 2011).

[19] Renfro v. Unisys Corp., No. 07-2098, 2010 WL 1688540, at *5 (E.D. Pa. Apr. 26, 2010).

[20] *Id.* at *9.

[21] *Id.* at *5.

motion to dismiss and a summary judgment motion based on the 404(c) safe harbor.[22]

The Third Circuit declined to rule on the safe harbor issue, but affirmed the Rule 12(b)(6) dismissal of the complaint on the basis of the large menu defense. The court observed that the plan included "seventy-three distinct investment options . . . company stock, commingled funds, and mutual funds . . . [representing] a variety of risk and fee profiles,"[23] thereby accomplishing ERISA's purpose of "offer[ing] participants meaningful choices about how to invest their retirement savings."[24] Following *Hecker's* lead, the court found that offering a large number of investment options insulated Unisys from liability as to the particular options it had selected for the plan.

The district court in *Renfro* took *Hecker* one step further by raising the possibility that, if the number of funds were a factor supporting liability, liability might arise from the offering of too *few* investment options in a plan, not too *many*. The court observed that, while the plan in *Hecker* included more than 2,500 options, "the *Hecker* court in no way indicated that fiduciaries to an ERISA plan breach their duty when they offer less than a few thousand investment options to plan participants."[25] In fact, a court had already found that offering too few options might increase a plan sponsor's liability risk.

In *Braden v. Wal-Mart*, the Eighth Circuit found that the relatively small number of investment options in Wal-Mart's 401(k) provided support for plaintiffs' claim that Wal-Mart had managed the plan imprudently.[26] As in *Hecker* and *Renfro*, a class of 401(k) participants alleged that the plan's fees were excessive and hidden, and that Wal-Mart had failed adequately to investigate lower-cost alternatives. The Wal-Mart plan offered only "ten mutual funds, a common/collective trust, Wal-Mart common stock, and a stable value fund." The court characterized the plaintiffs as alleging that the "[p]lan include[d] a relatively limited menu of funds which were selected by Wal-Mart executives despite the ready availability of better

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[22] Although the court did not rely on the control safe harbor *per se* in granting the motion to dismiss, it effectively adopted the safe harbor's reasoning. The following discussion treats this court as having applied the control safe harbor.

[23] 671 F.3d at 327.

[24] *Id.*

[25] *Renfro*, 2010 WL 1688540, at n.6.

[26] Braden v. Wal-Mart Stores, Inc., 588 F.3d 585 (8th Cir. 2009).

options."[27] It specifically compared Wal-Mart's small menu of options with the 2,500 mutual funds offered by the plan in *Hecker*, and quoted the *Hecker* court's finding that it was "untenable to suggest that all of the more than 2,500 publicly available investment options had excessive expense ratios."[28] In contrasting the present facts with *Hecker*, the court concluded that "[t]he far narrower range of investment options available in this case *makes more plausible the claim that this Plan was imprudently managed*."[29]

The *Renfro* court made the inverse relationship between *Hecker's* large menu defense and *Braden's* small menu stigma explicit in describing the cases as sharing a "similar analytical framework": "Both courts looked first to the characteristics of the mix and range of options and then evaluated the plausibility of claims challenging fund selection against the backdrop of the reasonableness of the mix and range of investment options."[30] The court in *Renfro* viewed small-menu *Braden* as taking the same approach as large-menu *Hecker* in declining to dismiss "in light of a plan that had far fewer available investment options than the plan in *Hecker*."[31]

The large menu defense caught the attention of the DOL, which objected to the Seventh Circuit's analysis in *Hecker*. In an *amicus* brief, the DOL complained that the court's decision would provide a defense for a fiduciary's imprudent selection of investment options if the fiduciary

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[27] *Id.* at 596.

[28] *Id.* at n.6 (quoting *Hecker*, 556 F.3d at 581).

[29] *Id.* (emphasis added); *see* Ruppert v. Principal Life Ins. Co., 796 F. Supp. 2d 959, 963 (S.D. Iowa 2010) (citing argument that limited menu in *Braden*, compared with large menu in *Hecker*, made imprudent management claim more plausible); Tibble v. Edison Int'l, 711 F.3d 1061, 1083 (9th Cir. 2013) (reiterating the argument in *Ruppert*).

[30] Renfro v. Unisys Corp., 671 F.3d 314, 326 (3d Cir. 2011).

[31] *Id.* at 327. ("We agree with our sister circuits' approach to evaluating these claims. An ERISA defined contribution plan is designed to offer participants meaningful choices about how to invest their retirement savings. Accordingly, we hold the range of investment options and the characteristics of those included options – including the risk profiles, investment strategies, and associated fees – are highly relevant and readily ascertainable facts against which the plausibility of claims challenging the overall composition of a plan's mix and range of investment options should be measured.").

simply selected a large number of options.[32] In response, the Seventh Circuit acknowledged that such a strategy would "result in the inclusion of many investment alternatives that a responsible fiduciary should exclude [and] . . . place an unreasonable burden on unsophisticated plan participants who do not have the resources to pre-screen investment alternatives."[33] This concession seemed to reflect the court's reconsideration of the large menu defense, but the court said nothing about this "burden on unsophisticated plan participants" lessening their ultimate responsibility for losses under the safe harbor. Nor did the court disavow the dispositive weight afforded to the offering of a large number of investment options in determining whether the participant had exercised control over his account.

The Seventh Circuit soon removed any doubt about its commitment to the large menu defense. In *Loomis v. Exelon Corp.*,[34] the court relied on *Hecker's* large menu defense to dismiss hidden-excessive fee claims against Exelon Corp.[35] Its understanding of *Hecker* and *Hecker II* was unambiguous: "By offering a wide range of options, *Hecker* held, Deere's plan complied with ERISA's fiduciary duties. Plaintiffs contend that the

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[32] Amended Brief of the Sec'y of Labor, Elaine Chao, as Amicus Curiae in Support of Plaintiffs-Appellants, Hecker v. Deere & Co., 2008 WL 5731147 (7th Cir. April 4, 2008) (No. 08-1224).

[33] Hecker v. Deere & Co., 569 F.3d 708, 711 (7th Cir. 2009) [hereinafter *Hecker II*]. Phyllis Borzi, the Assistant Secretary for the Employee Benefits Administration, has cited finding "'a disturbing trend' among plan sponsors seeking to avoid ERISA responsibility by 'just giving choices'" in reference to 401(k) brokerage account windows. Hazel Bradford, *Borzi: Sponsors Have Always Been Responsible for Monitoring Brokerage Windows*, PENSION & INVESTMENTS (June 18, 2012), http://www.pionline.com/article/20120618/DAILYREG/120619900/borzi-sponsors-have-always-been-responsible-for-monitoring-brokerage-windows. This statement was made in the context of guidance issued by the Department of Labor ("DOL") in May 2012 that took the position that employers may be responsible for decisions made within a 401(k) brokerage account window. *See* Robert Steyer, *Labor Department Stands Firm on Self-Directed Brokerage Account Guidance*, PENSION & INVESTMENTS (Aug. 6, 2012), http://www.pionline.com/article/20120601/DAILYREG/120609983/labor-department-stands-firm-on-self-directed-brokerage-account-guidance. The DOL later withdrew that position under industry pressure. *See* Robert Steyer, '*Intensive' Lobbying Behind DOL Turnabout on DC Plan Brokerage Window*, PENSION & INVESTMENTS (Aug. 6, 2012), http://www.pionline.com/article/20120806/PRINTSUB/308069984.

[34] Loomis v. Exelon Corp., 658 F.3d 667 (7th Cir. 2011).

[35] *Id.*

panel in *Hecker* retreated from this holding when denying a petition for rehearing [in *Hecker II*]. It did not."[36]

The court characterized *Hecker* as having "held that as a matter of law that [Deere offered] an acceptable array of investment options, observing that 'all of these funds were also offered to investors in the general public, and so the expense ratios necessarily were set against the backdrop of market competition.'"[37]

The *Loomis* court applied the *Hecker* large menu defense in finding that Exelon could not be faulted if it selected hidden excessive fee options for the plan because, with thirty-two investment options to choose from,

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[36] *Id.* at 670. Notwithstanding the court's definitive statement that *Hecker II* did not represent a change in the court's position, the DOL has argued that *Hecker II* "backed away" from the "breadth of its earlier ruling," citing the Seventh Circuit's subsequent decision in *Howell*. Howell v. Motorola, Inc., 633 F.3d 552 (7th Cir. 2011). *See* Brief for the Sec'y of Labor as Amicus Curiae in Support of Plaintiffs-Appellants, Tibble v. Edison Int'l, 2011 WL 2178417 at *24 (9th Cir. May 25, 2011) (No. 10-56415) (quoting *Howell*, 633 F.3d at 567 (citing *Hecker*, 569 F.3d at 708)). However, *Howell* involved the prudence of offering an employer stock option in the plan, and courts have applied a different, arguably inconsistent standard in cases involving employer stock. *Howell*, 633 F.3d. at 567. *Howell's* position on the responsibility of employers for imprudently selecting employer stock as an option directly contradicts the same court's position on the selection of other types of options: "The choice of which investments will be presented in the menu that the plan sponsor adopts is not within the participant's power. It is instead a core decision relating to the administration of the plan and the benefits that will be offered to participants. . . . It is . . . the fiduciary's responsibility . . . to screen investment alternatives and to ensure that imprudent options are not offered to plan participants. *Id.* Although beyond the scope of this article, it is worth noting that courts such as *Howell* have been more willing to second-guess employers' choice of employer stock as an option than diversified mutual funds notwithstanding that ERISA provides a specific statutory safe harbor for employer stock. *See* 29 U.S.C. § 1104(a)(2) (2011); *see*, *e.g.*, Pfeil v. State Street Bank & Trust Co., 671 F.3d 585 (6th Cir. 2012); Peabody v. Davis, 636 F.3d 368 (7th Cir. 2011); DiFelice v. U.S. Airways, Inc., 497 F.3d 410 (4th Cir. 2007); Langbecker v. Elec. Data Sys. Corp., 476 F.3d 299 (5th Cir. 2007); Dann v. Lincoln Nat'l Corp., 274 F.R.D. 139 (E.D. Pa. 2011).

[37] *Loomis*, 658 F.3d at 670 (quoting *Hecker*, 556 F.3d at 586). *See* Spano v. Boeing, 633 F.3d 574, 586 (7th Cir. 2011) ("*Cf. Hecker*, 556 F.3d 575, 584–87 (7th Cir. 2009) (noting that the record showed sufficient variety in investments and fee levels to satisfy ERISA requirements)"); Loomis v. Exelon Corp., No. 06 CV 4900, 2009 WL 4667092 at *3 (N.D. Ill. Dec. 9, 2009) (endorsing *Hecker's* "sufficient mix of investments defense").

"[a]ny participant who want[ed] a fund with expenses under 0.1% can get it through Exelon's Plan."[38] The court appeared to believe that the employer did not have a fiduciary duty to abjure excessive or hidden fee investment options for its plan because the large number of options offered ensured that at least one low-cost option was available.

Thus, the Third, Seventh and Eighth Circuits have taken the position that a large 401(k) menu can protect a plan fiduciary from liability for imprudently selecting investment options for the plan. Even assuming that the plan fiduciary violated Section 404(c)'s prudent man standard in the selection of investment options, the availability of a large number of options abrogated the fiduciary's legal responsibility under ERISA. Conversely, offering a small menu of investment options, as in *Wal-Mart*, made it "more plausible" that the plan was imprudently managed. The large menu defense courts view participants as having exercised safe harbor control when the number of investment options is large enough that the participants' choices become the effective, proximate cause of any losses resulting from, for example, excessive fees.

Although no other court has directly addressed the large menu defense, the Ninth Circuit has rejected the mainstay of the large menu defense theory that employers' responsibility for imprudently selecting investment options can be abrogated in the context of a menu of diversified investment options. In *Tibble v. Edison Int'l*, the court explained that treating a participant's act of choosing an investment option as abrogating the employer's responsibility for selecting options could not be reconciled with the plain meaning of the statute.[39] The court found that considering the participant's investment decision as an intervening cause of the participant's loss, *i.e.*, a safe-harbor exercise of control, "would render parts of the ERISA statute a nullity by making it nearly impossible for defined-contribution-plan beneficiaries to vindicate fiduciary imprudence."[40] Defendants in ERISA cases would *always* be able to pass

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[38] *Loomis*, 658 F.3d at 671.

[39] Tibble v. Edison Int'l, 711 F.3d 1061, 1074 (9th Cir. 2013). In *Tibble*, the court affirmed the district court's finding that the employer had imprudently failed to consider the potential cost savings of selecting institutional rather than retail classes of mutual fund shares. During the relevant period, the plan at issue offered from six to fifty investment options. *See* Tibble v. Edison Int'l, 639 F. Supp. 2d 1074, 1081 (C.D. Cal. 2009). Neither the district court nor the Ninth Circuit addressed the issue of the size of the menu.

[40] *Tibble*, 711 F.3d at 1074 (citing LaRue v. DeWolff, Boberg & Assocs., Inc., 552 U.S. 248, 256 (2008) (citing the DOL's regulations implementing section

responsibility for losses to participants because "there can be no loss without the participant selecting an investment."[41] The *Tibble* court agreed with the DOL's view that the employer's selection of investment options necessarily precedes the participant's investment decision and therefore should reasonably be viewed as the most salient cause of losses arising from the inclusion of a particular option in the 401(k) menu.[42] As explained in *Tibble*, the large menu defense contradicts the plain meaning of the control safe harbor.

The large menu defense interpretation of the control safe harbor also fails because it misreads the purpose of the safe harbor's "broad range of investment alternatives" requirement. The courts view the broad-range requirement as reflecting a policy favoring large menus, as if its purpose were to maximize participant choice. The *Renfro* court stated that "[a]n ERISA defined contribution plan is designed to offer participants meaningful choices,"[43] which *Loomis* echoed in characterizing the 404(c) safe harbor as "encourag[ing] sponsors to allow more choice to participants in defined-contribution plans."[44] The courts interpret the safe harbor's diversification requirement as reflecting Congress's wish that employers offer as many options as feasible to provide participants with the greatest possible control over their investments.

This choice-for-choice's sake view misunderstands that the broad-range requirement is designed to promote diversification, not large menus. It is intended to incentivize employers to offer menus that enable participants to construct an efficient portfolio with appropriate risk-return characteristics.[45] The diversification purpose of the broad-range

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404(c) in rejecting the converse interpretation) and *Langbecker*, 476 F.3d at 321 (Reavley, J., dissenting) ("All commentators recognize that § 404(c) does not shift liability for a plan fiduciary's duty to ensure that each investment option is and continues to be a prudent one.")).

[41] *Tibble*, 711 F.3d at 1073 ("For a 401(k) (or for any defined-contribution plan for that matter), it is admittedly the case that monetary damage flowing from a fiduciary's imprudent design of the investment menu passes through the participant, as intermediary. But is it proper to conclude that those losses, in the language of section 404(c), 'result from' the participant's choice? This might seem an odd question given that, literally speaking, there can be no loss without the participant selecting an investment.").

[42] *Id.*

[43] Renfro v. Unisys Corp., 671 F.3d 314, 327 (3d Cir. (2011).

[44] Loomis v. Exelon Corp., 658 F.3d 667, 673 (7th Cir. 2011).

[45] A "broad range of investment alternatives" has been provided if the

requirement is illustrated by the following example. If a participant who planned to retire in 2008 had invested 100% of her assets in stock funds (which would have declined precipitously that year), that unfortunate allocation decision would have reflected her exercise of control if the employer had provided a diversified menu of options, including fixed income options in which she could have invested to create a more appropriate portfolio.[46] The allocation would have been entirely outside the employer's control.[47] In contrast, if the stock funds that she chose were

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participant has an opportunity to: (1) materially affect the potential return and degree of risk of the account;, (2) diversify to as to minimize the risk of large losses; and (3) choose from at least three diversified investment options. These investment options must have materially different risk and return characteristics such that they can be combined in a portfolio: (1) with aggregate risk-return characteristics that are within the range that is appropriate for the participant and (2) that tends to minimize the risk of the overall portfolio. *See* 29 C.F.R. § 2550.404c–1.

[46] As stated by the Seventh Circuit in an employer-stock option case, "it would make no sense [under the 404(c) safe harbor] to blame the fiduciary for the participant's decision to invest 40% of her assets in Fund A and 60% in Fund B, rather than splitting assets somehow among four different funds, emphasizing A rather than B, or taking any other decision." Howell v. Motorola, Inc., 633 F.3d 552, 567 (7th Cir. 2011). (As noted earlier, the Seventh Circuit has not applied its analysis in employer-stock cases to cases involving the selection of other types of investment options.) The *Hecker* and *Loomis* courts effectively held that choosing an excessive fee option over a non-excessive fee option from a large menu is the equivalent of choosing Fund A over Fund B, in that the participant's decision is the proximate cause of both decisions. But the *Hecker* and *Loomis* analysis does not make sense as an interpretation of the DOL's "broad range" requirement. That requirement is designed to produce a menu with diversified risk/return characteristics; it is not designed to produce a menu that is diversified in the sense of offering a mix of excessive and non-excessive fee options.

[47] Although the participant's allocation may have been the legal cause of the losses, research shows that the selection of the menu, even if it is adequately diversified, also bears a causal relationship to the participant's allocation. For example, participants will invest a much higher percentage of plan assets in stock funds when a plan offers a mix of four stock funds and one bond fund than when the plan offers a mix of one stock fund and four bond funds. *See* Shlomo Benartzi & Richard H. Thaler, *Naive Diversification Strategies in Defined Contribution Saving Plans*, 91 AM. ECON. REV. 79, 87 (2001) (finding that when equity options comprised a larger percentage of hypothetical options, study subjects invested a larger percentage of accounts in equities than when equity options comprised a smaller percentage of options), *available at* http://www.anderson.ucla.edu/

imprudently selected because they charged excessive fees, then the employer would be responsible for the losses due to the excessive fees. Although the employee chose the excessive fee option, and there may have been stock funds in the menu that did not charge excessive fees, the employer's selection of the options would have been the proximate, preceding cause of the loss. Whether the total number of options was large or small is irrelevant to the employer's responsibility for the imprudent selection of the excessive fee option.

In summary, some courts have dismissed claims that an employer violated the prudent man standard by placing excessive fee investment options in its 401(k) plan based on a large menu defense. The courts have reasoned that when a 401(k) plan offers a large number of investment options, any losses due to the imprudent selection of an investment option resulted not from the employer's selection of the investment option, but from the participant's exercise of control in choosing to invest in the option. This position is inconsistent with ERISA because the preceding proximate cause of losses due to the inclusion of an imprudently selected investment in the plan is, in fact, the employer's decision to include the investment in the plan. The courts' large menu defense cannot be reconciled with a reasonable reading of the control safe harbor. The courts also seem to misunderstand that the purpose of the safe harbor's legal incentives to offer a broad range of investment alternatives is not to inflate the size of 401(k) menus, but to encourage employers to offer an appropriately diverse set of options. However, the large menu defense may reflect less of a disagreement about the nature of causation or the meaning of the safe harbor than a more fundamental ideological view that the regulation of plan participants' 401(k) investments should be left to the marketplace rather than ERISA's fiduciary duties.

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documents/areas/fac/accounting/naive_diversification.pdf; *see also* Jeffrey Brown et al., *Individual Account Investment Options and Portfolio Choice: Behavioral Lessons from 401(K) Plans* (NBER Working Paper, No. 13169, June 2007) (increasing equity fund representation from 1/3 to 1/2 of menu increased participants' equity allocations by 7.5%) ("*Behavioral Lessons*"), *available at* http://www.nber.org/papers/w13169.pdf?new_window=1; Anders Karlsson et al., *Portfolio Choice and Menu Exposure,* EFA 2006 Zurich Meetings (February 7, 2006) (likelihood of option being chosen increases with its representation in menu), *available at* http://ssrn.com/abstract=888661 or http://dx.doi.org/10.2139/ssrn.888661.

III. FREE MARKETS, LARGE MENUS AND THE FIDUCIARY STANDARD

The remainder of this article discusses two major concerns regarding the large menu defense. The first concern is that the large menu defense evinces a judicial decision to evaluate employers' legal responsibilities on the basis of judges' free market ideology instead of employers' fiduciary duties under ERISA. These judges prefer that economic activities be allowed to operate pursuant to free market axioms, which conflicts with the imposition of a fiduciary duty on employers. The large menu defense reflects the particular free market axiom that offering plan participants the widest possible range of choice in their 401(k) plans maximizes social wealth. However, this position is fundamentally incompatible with the mandate in ERISA to enforce the paternalistic principles that a fiduciary duty inherently entails, as discussed further in this section. The second concern presented by the large menu defense, as discussed in Section IV, is that the courts' view that large 401(k) menus are wealth-maximizing is empirically false. Large 401(k) menus make workers poorer, not wealthier.

The large menu defense is generally based on the view that free market principles are superior to fiduciary duties in regulating employers' selections of 401(k) investment options. The defense views a large 401(k) menu as effectively a marketplace in which the only legally controlling factor is the participant's role in choosing an investment. Courts in favor of the large menu defense found that participants were responsible "because of the nature and breadth of funds made available," "the numerous investment options," and "the wide range of expense ratios among" the funds offered. The plans offered a "variety of risk and fee profiles" constituting "meaningful choices about how to invest their retirement savings" and included enough investment options from which "to create a portfolio tailored to meet [participants'] investment objectives."

A plan that replicates an open marketplace effectively abrogates the employer's legal responsibility for selecting investment options for the plan. In contrast, Wal-Mart's "narrower range of investment options" made "it more plausible . . . that the Plan was imprudently managed" because the invisible hand of the market was replaced with the visible hand of the employer. Where the number of plans is small, the employer may be faulted for interfering with free market forces by narrowing participants' investment decisions to an artificially limited set. If employers allow the invisible hand free reign, then they will be relieved of liability.

This ideology is illustrated in *Hecker*, as quoted approvingly in *Loomis*, where the court notes that Deere's 401(k) funds "were also offered to investors in the general public, and so the expense ratios necessarily were set against the backdrop of market competition."[48] The *Renfro* court was similarly skeptical of plaintiffs' claim that fees were excessive with respect to "funds that are available on the same terms to individual investors in the open market."[49] In *Loomis*, it did not matter that an employer chose excessive fee options for the plan; "[a]ny participant who want[ed] a fund with expenses under 0.1% [could] get it through Exelon's Plan."[50] The courts' marketplace theory of liability essentially finds that an employer can shed its fiduciary role in selecting 401(k) investment options by choosing a menu that replicates the marketplace.

The market-based criteria on which these courts based the large menu defense contradict not only the plain meaning of the control safe harbor, as discussed *supra* in Section II, but also the essential nature of the fiduciary duty. Judge Cardozo's iconic characterization of the fiduciary duty in *Meinhard v. Salmon* tees up the fundamental conflict between fiduciary duties and market-based principles:

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.[51]

In the fiduciary context, pure market dynamics cannot be relied upon to yield the sought-after social benefits of commercial activities. Fiduciary principles, therefore, are not circumscribed by the rules that apply to commercial, "arm's length" relationships, but are based on non-market criteria because markets are not always efficient. Inefficiencies can reduce the social utility of market-based transactions. These inefficiencies may arise from a host of factors, including unequal bargaining positions, informational asymmetries, monopoly power, bounded rationality and/or

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[48] *See supra* note 37.

[49] Renfro v. Unisys Corp., 671 F.3d 314, 326 (3d Cir. 2011).

[50] *Loomis,* 658 F.3d at 671.

[51] Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

rent-seeking regulation.[52] Judge Cardozo may not have been thinking in terms of economic theory yet to take concrete form, but he nevertheless understood that, in the face of market inefficiencies, "honesty alone," *i.e.*, requiring only that a fiduciary refrain from fraud or other misrepresentation, was inadequate to ensure that free market activities would increase, rather than reduce, net social wealth.

Common law and statutory fiduciary duties reflect, respectively, courts' and legislators' decisions to modify or supplant market forces with external rules in situations in which market-based principles are likely to fail to create the social benefits of commercial activities. While there is a robust scholarship about when and to what extent fiduciary duties are actually wealth-maximizing,[53] there is general agreement with the position that fiduciary duties are intended to and do, in fact, modify or supplant market forces. They reflect an inherently paternalistic view that, when fiduciary duties apply, courts and legislatures should redirect the natural course of commerce even if doing so replaces the usually wealth-maximizing decisions of rational economic actors with the judgment of government actors.

In short, courts applying the large menu defense simply disagree with Congress's decision to impose fiduciary duties on employers when selecting 401(k) investment options. The *Loomis* court revealed the ideological nature of its disagreement with Congress in charging that the problem in that case was that the "[p]laintiffs' theory is paternalistic."[54] This statement, taken literally, is absurd because the legal theories underlying a fiduciary claim are necessarily paternalistic. ERISA is paternalistic to its core. The Congressional findings and declaration of policy in ERISA speak of protecting the interests of plan beneficiaries "by establishing standards of conduct, responsibility, and obligation for

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[52] *See, e.g.*, Restatement (Third) of Trusts § 78 cmt. b (2007).

[53] *See*, *e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1996) (discussing the scope of managers' duties in the context of the corporation and the corporate contract). *See also* Paul Mahoney, *The Common Law and Economic Growth: Hayek Might be Right* (Univ. of Virginia Law School Legal Studies, Working Paper No. 00-8, Jan. 2000) (finding higher rates of real per capita growth in common law economies); Ross Levine et al., *Financial Intermediation and Growth: Causality and Causes* (World Bank Policy Research, Working Paper No. 205, Feb. 1999) (finding that common law systems enhance financial intermediary development, which causes higher economic growth), *available at* http://ssrn.com/abstract=247793.

[54] 658 F.3d at 673.

fiduciaries of employee benefit plans, and by providing for appropriate remedies, sanctions, and ready access to the Federal courts."[55] Congress sought to protect the interests of participants "by improving the equitable character and the soundness of such plans."[56] These broad, paternalistic goals look to decidedly non-market-based rules to regulate the operation of pension benefit plans.

The ERISA prudent man and prohibited transaction rules give concrete form to the paternalistic structure and purpose of ERISA. Employee pension plans are *required* to have a fiduciary and a fiduciary is *required* to assume fiduciary duties with respect to the structure and operation of the plan, including selecting investment options in the plan. ERISA's prohibited transaction rules narrowly circumscribe or flatly prohibit transactions that normally would be subject only to the rules that apply to arm's-length deals. ERISA empowers employers to automatically enroll employees in a plan and invest an employer-determined percentage of the employee's wages in an employer-selected investment option when employees have not affirmatively taken these steps themselves.[57]

Regardless of whether ERISA's paternalism is good policy, its paternalism is undeniable. It is difficult to understand how the *Loomis* court could criticize the "[p]laintiffs' theory" for being "paternalistic" when the private cause of action on which the theory is based is intrinsically paternalistic. This contradiction is sharpened by the fact that the *Loomis* opinion's author, Judge Frank Easterbrook, established his reputation as a scholar by elucidating the paternalistic nature of fiduciary duties and identifying situations in which he believed that fiduciary duties should be waivable or eliminated.

As a member of the judiciary, Judge Easterbrook has previously attempted, albeit unsuccessfully, to substitute a market-based test for an express fiduciary duty under federal law. In *Jones v. Harris Associates*

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[55] 29 U.S.C. § 1001(b) (2006).

[56] 29 U.S.C. § 1001(c) (2006).

[57] ERISA's automatic enrollment provision is the regulatory policy most extensively discussed in Richard Thaler's and Cass Sunstein's best-seller, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS, which is based on a regulatory model that they call "libertarian paternalism." RICHARD THALER & CASS SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS (2008).

L.P.,[58] he authored the opinion that affirmed the dismissal of a claim under section 36(b) of the Investment Company Act of 1940, which provides that "the investment adviser of a registered investment company shall be deemed to have a *fiduciary duty* with respect to the receipt of compensation for services."[59] Prior to *Jones*, courts had generally interpreted section 36(b) under a fiduciary standard established by the Second Circuit twenty-five years earlier in *Gartenberg v. Merrill Lynch Asset Management, Inc.*[60] The Seventh Circuit rejected the *Gartenberg* standard in holding that the fiduciary duty under section 36(b) could only be violated if the fees paid were "'so unusual' as to give rise to an inference 'that deceit must have occurred, or that the persons responsible for decision have abdicated.'"[61] As in *Loomis*, the court's decision was based on its view that market forces, not fiduciary duties, should be the exclusive determinant of prices, and that "honesty alone" *was* enough.

The Supreme Court unanimously reversed the Seventh Circuit's *Jones* decision.[62] The Court's analysis is instructive as to the incompatibility of strictly market-based rules of construction and the intrinsically paternalistic nature of the fiduciary duty. It pointedly summarized the Seventh Circuit's *Jones* analysis as follows:

> The panel argued that this [deceit-based] understanding of § 36(b) is consistent with the forces operating in the contemporary mutual fund market. Noting that "[t]oday thousands of mutual funds compete," the panel concluded that "sophisticated investors" shop for the funds that produce the best overall results, "mov[e] their money elsewhere" when fees are "excessive in relation to the results," and thus "create a competitive pressure" that

[58] Jones v. Harris Assocs. L.P., 537 F.3d 728 (7th Cir. 2008), *vacated* 559 U.S. 335, 353 (2010). In the interests of full disclosure, this author was an expert witness in *Jones*.

[59] 15 U.S.C. § 80a-35(b) (2006) (emphasis added).

[60] Gartenberg v. Merrill Lynch Asset Mgmt., 694 F.2d 923 (2d Cir. 1982).

[61] 537 F.3d at 732.

[62] As the Wall Street Journal editorial page has noted, "It isn't easy to lose 9 - 0 on the current ideologically divided Supreme Court." Editorial, *Supremes 9, SEC 0*, WALL ST. J., Feb. 27, 2013, *available at* http://online.wsj.com/article /SB10001424127887324662404578330260976961512.html?mod=WSJ_Opinion_ AboveLEFTTop.

> generally keeps fees low. The panel faulted *Gartenberg* on the ground that it "relies too little on markets."[63]

The Court flatly rejected the idea that markets set the boundaries of Section 36(b)'s fiduciary duty.[64] Instead, it treated Section 36(b)'s "fiduciary duty" as a *fiduciary* duty. The Court adopted the traditional fiduciary standard that it applied in *Pepper v. Litton* in 1939—notably reaching back to the era of Cardozo's fiduciary duty in *Meinhard*—which involved a "dominant or controlling shareholder's claim for compensation against a bankrupt corporation."[65] Under that classically paternalistic standard, the shareholder had the burden not only "to prove the good faith of the transaction but also to show its inherent fairness." [66] The Court's holding reflected its understanding that a statutory fiduciary duty represents the legislature's decision not to defer blindly to the "morals of the marketplace" because free market forces will not always yield an optimal outcome.

One basis for the Court's decision was its recognition that free markets are not, in fact, necessarily wealth-maximizing. It warned that, in applying Section 36(b), "courts should not rely too heavily on comparisons with fees charged to mutual funds by other advisers. These comparisons are problematic because these fees, like those challenged, *may not be the product of negotiations conducted at arm's length*."[67]

In support of this statement, the Court cited the dissent from the Seventh Circuit's denial of a rehearing en banc,[68] in which Judge Richard Posner had argued that "the panel base[d] its rejection of *Gartenberg* mainly on an economic analysis that is ripe for reexamination on the basis of growing indications that executive compensation in large publicly traded firms often is excessive because of the feeble incentives of boards of

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[63] *Jones*, 559 U.S. at 342 (quoting *Jones*, 527 F.3d at 632).

[64] *Jones*, 335 U.S. at 353. *E.g. id.* ("By focusing almost entirely on the element of disclosure, the Seventh Circuit panel erred. An investment adviser 'must make full disclosure and play no tricks but is not subject to a cap on compensation.'") (quoting *Jones*, 527 F.3d at 632)).

[65] *Jones*, 335 U.S. at 346 (citing Pepper v. Litton, 308 U.S. 295, 306 (1939)).

[66] *Id.* at 346-47 (quoting *Pepper*, 308 U.S. at 306-07).

[67] *Id.* at 350-51 (emphasis added).

[68] *Id.* (citing *Jones*, 537 F.3d at 731); *id.* ("Competition between money market funds for shareholder business does not support an inference that competition must therefore also exist between [investment advisers] for fund business. The former may be vigorous even though the latter is virtually non-existent.") (quoting *Gartenberg*, 694 F.2d at 929).

directors to police compensation.[69] Judge Posner continued, "[c]ompetition in product and capital markets can't be counted on to solve the problem because the same structure of incentives operates on all large corporations and similar entities, including mutual funds."[70] The *Jones* case suggests that, if the large menu defense reaches the Court, it will be struck down just as decisively as the Seventh Circuit's holding in *Jones*.

Possibly concerned about being reversed on appeal again, Judge Easterbrook attempted to distinguish *Jones* from *Loomis* on the ground that the defendant in a section 36(b) case has a conflict of interest. A fund manager directly benefits from the receipt of fees that the section 36(b) plaintiff alleges are excessive. In contrast, "there is no reason to think that Exelon chose the funds to enrich itself at participants' expense."[71] However, there is no support, and the *Loomis* court cited none, for the proposition that fiduciary liability under ERISA attaches only with proof of the fiduciary's self-dealing motive. To the contrary, "the great principles of trust fiduciary law, loyalty and prudence, do not depend upon the transferor's motive, whether making a gift or doing a deal."[72] A trustee is

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[69] *Jones*, 537 F.3d at 730 (Posner, J., dissenting).

[70] *Id.*

[71] *Loomis*, 658 F.3d at 671 ("[E]xelon had (and has) every reason to use competition in the market for fund management to drive down the expenses charged to participants, . . . Competition thus assists both employers and employees, as Hecker observed."). It is hard to take this distinction seriously, as Judge Easterbrook made the same argument in Jones that a fund manager has the same market-based incentive to keep fees low:

> Holding costs down is vital in competition, when investors are seeking maximum return net of expenses—and as management fees are a substantial component of administrative costs, mutual funds have a powerful reason to keep them low unless higher fees are associated with higher return on investment. A difference of 0.1% per annum in total administrative expenses adds up by compounding over time and is enough to induce many investors to change mutual funds. That mutual funds are "captives" of investment advisers does not curtail this competition. An adviser can't make money from its captive fund if high fees drive investors away.

Jones, 527 F.3d at 631-32.

[72] John H. Langbein, Essay, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 YALE L.J. 165, 186 (1997).

bound to the duties it has assumed regardless of whether it may personally benefit from any alleged malfeasance, just as ERISA's prudent man standard applies regardless of whether violating it is accompanied by a financial benefit to the fiduciary.

The *Loomis* court's preference for free market principles in derogation of express statutory fiduciary duties reveals the ideological nature of its position that ERISA fiduciary claims must conform to an overriding, rational-actor model of human behavior. Yet the Supreme Court rejected precisely this approach in *Jones*, namely, the court's substitution of its own economic analysis for Congress's decision to qualify the primacy of the rational actor model by imposing a fiduciary duty in certain situations. If and when the market-based, large menu defense reaches the Court, it is likely to suffer the same fate as the market-based approach taken in *Jones*.

The large menu defense goes further than exalting free market principles over plain statutory mandates; it re-interprets ERISA's diversification requirement as a paean to the liberation ideology of free choice. Courts in favor of the large menu defense consider choice-maximization to be a central purpose of ERISA. *Tibble*'s "centerpiece" of ERISA was "participant choice."[73] *Renfro* viewed ERISA's diversification standard as "being designed to offer participants meaningful choices,"[74] as echoed by *Loomis*'s view that its purpose was, "[f]ar from reflecting a paternalistic approach, [to] encourage sponsors to allow more choice to participants."[75] *Loomis* applauded *Exelon* because, as directed by the safe harbor, it had "left choice to the people who have the most interest in the outcome, and it cannot be faulted for doing this."[76]

The courts' view that the purpose of ERISA is to maximize participant choice, which turns the statute on its head. Congress did not enact ERISA to generate more investment choices for workers; it enacted ERISA to enhance their retirement security. As noted herein, ERISA reflects a strongly paternalistic view of pension plans.[77] Congress did not

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[73] *Tibble*, 711 F.3d at 1083.

[74] *Renfro*, 671 F.3d at 327.

[75] *Loomis,* 658 F.3d at 673.

[76] *Id.*

[77] *See* 29 U.S.C. § 1001 (b)-(c) (2012); *Loomis*, 658 F.3d at 673; RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS (2008) (showing that ERISA's automatic enrollment provision is the regulatory policy and is based on a regulatory model that the authors call "libertarian paternalism").

enact ERISA to free workers of some imaginary yoke of oppression imposed by employers that offer a limited menu of 401(k) investment options. Rather, Congress intended that ERISA *restrict* employers' and workers' discretion, respectively, in offering and choosing investments.

The large menu defense treats consumer choice as an end in itself; under ERISA, it is only a means to an end. The statute does not require choice for choice's sake. The 404(a) safe harbor mandates at least three diversified investment options as a means of maximizing plan participants' wealth, not as a means of promoting individual freedom. The DOL conditions the safe harbor on plans' offering a "broad range of investment alternatives" not in order to enhance rational actors' ability to maximize their personal utility, but to maximize the wealth of plan participants as a group based on the government's faith in a particular theory of investing (modern portfolio theory).[78]

The incentives that ERISA offers to employers to offer multiple investment options, as well as related DOL regulations and interpretation, reflect patently paternalistic public policy decisions about what is best for workers. These policies are decidedly not motivated by a liberation ideology of individual freedom and choice. The safe harbors relieve employers of liability for following government guidelines in selecting investment options, not for seeking to maximize plan participant freedom. The courts' re-characterization of a government mandate based on modern portfolio theory as a policy of liberation designed to maximize worker freedom is nothing more than wishful thinking, statutory nullification, or both.

IV. JUDICIAL ECONOMICS AND THE EMPIRICAL CONSEQUENCES OF LARGE 401(K) MENUS

As discussed immediately above, the large menu defense is based on the courts' belief that ERISA's prudent man rule is rendered inoperative

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[78] 29 C.F.R. § 2550.404c-1(b)(1)(ii) (2010). *See* Philip J. Ruce, *The Trustee and the Prudent Investor: The Emerging Acceptance of Alternative Investments as the New Fiduciary Standard*, 53 S. TEX. L. REV. 653, 666-68 (2012) (discussing relationship between modern portfolio theory and the prudent investor rule); W. Scott Simon, *Illuminating the 'Broad Range' Requirement of ERISA Section 404(c) With the Language of Modern Portfolio Theory Found in the Uniform Prudent Investor Act and the Restatement 3rd of Trusts (Prudent Investor Rule)*, 13 J. PENSION BENEFITS 87 (2005) .

as to an employer's selection of 401(k) investment options if the employer offers a large enough number of investment options. By offering a large menu of options, the employer in *Loomis*, for example, "left choice to the people who have the most interest in the outcome, and it cannot be faulted for doing this."[79] In contrast, employers such as Wal-Mart, that paternalistically limit the number of investment options, thereby increase their ERISA liability risk. This judicial exercise of extralegal authority is reason to be concerned, but if the courts' faith in the wealth-maximizing effect of choice in 401(k) plans is well-founded, then at least workers would be wealthier as a result.

However, larger 401(k) menus actually reduce workers' wealth. Research demonstrates that the assumption made by free market ideologues that increasing choice in 401(k) plans maximizes wealth is empirically false. The courts supporting the large menu defense do not cite any research to support their view of the economic benefits of large 401(k) menus; they seem entirely indifferent as to whether their theories bear any relation to reality. The effect of the large menu defense is to make workers poorer, while also creating a perverse incentive for employers to reduce their ERISA liability risk by adding more options to their 401(k) plans.

The large menu defense reflects the courts' view of the model of plan participants as rational utility maximizers. Traditional free market theory assumes that economic actors are rational. Consumers make choices to maximize their personal wealth, or "utility." A larger set of choices should enhance consumers' abilities to maximize their utility because with every additional choice, the chance that the set of options will include the most utility-maximizing option for a particular consumer increases.[80] Larger 401(k) menus should therefore be wealth maximizing because they increase the likelihood that the set of investment options will include utility-maximizing options for every participant. The more flavors of ice cream that are available, the greater the likelihood that the consumer's favorite flavor will be among them. Conversely, restricting the size of 401(k) menus should reduce participants' wealth because a smaller menu is less likely to include the particular investment that will maximize a participant's utility.

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[79] *Loomis*, 658 F.3d at 673-74.

[80] *See generally* Sheena S. Iyengar &Wei Jiang, *The Psychological Costs of Ever Increasing Choice: A Fallback to the Sure Bet* 3 (Columbia Univ., Working Paper, 2005) (discussing rational choice theory).

In practice, however, offering more choices to consumers adversely affects their ability to maximize their utility. For example, numerous studies have shown that offering subjects a small set of purchase options increases the likelihood that they will make a purchase. One prominent study found that shoppers were more likely to buy jam when offered six flavors to choose from instead of twenty-four. One reason for the adverse effect of providing more choices may be that choice creates stress, which was illustrated by a study in which subjects were made to choose from among an array of Godiva chocolates. They reported feelings of regret and less certainty when offered thirty chocolates than when offered only six. Thus, *reducing* the number of available choices can create both material and psychological benefits.

While investment options in 401(k) plans are a far cry from jams and chocolates, the effects of offering more choice to plan participants is the same – and vastly more costly. Studies have shown that large menus have the effect of substantially reducing plan participation rates, thereby resulting in huge financial losses to workers. There is also empirical evidence that large menus result in investment options that are lower quality and more expensive, lead to inferior asset allocation decisions, and impair the effectiveness of disclosure due to information overload. The aggregate effects of the consequences of large menus are an annual deadweight wealth reduction of billions of dollars and a less secure retirement for millions of Americans.

A. Large Menu Effects – Reduced Participation Rates

The most prominent study on the effect of large 401(k) menus is also the most comprehensive. Three Columbia University researchers studied the participation rates of more than 800,000 employees across 647 plans.[81] In short, they found that, with every ten additional options, the plan's participation rate declined by approximately two percentage points. As the number of investment options increased from two to eleven, the participation rate declined steadily from 75% to 70%. The participation rate remained at approximately 70% as the number of options increased from eleven to thirty, at which point the rate began to decline approximately two percentage points for each ten-option increase. The

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[81] *Id* at 2. *See also* GARY R. MOTTOLA & STEPHEN P. UTKUS, VANGUARD CTR. FOR RET. RES., CAN THERE BE TOO MUCH CHOICE IN A RETIREMENT SAVINGS PLAN? (2003) (summarizing and commenting on Iyengar & Jiang, *supra* note 80).

participation rate declined to 67% when the number of investment options increased to thirty-five, and declined further to 61% when the number of options reached fifty-six.[82]

These data take on a human face when applied to an actual 401(k) plan. As discussed herein, Deere's plan included twenty-five core mutual fund options and 2,500 additional funds. The plan had approximately 31,000 participants,[83] which would represent a participation rate ranging from 61% to 68%, depending on whether one treated the plan as offering more than fifty-six options (61%) or only twenty-five options (68%).[84] If the plan had offered only two options and achieved a 75% participation rate, it would have had approximately 38,000 participants under the fifty-six-plus-options assumption and 34,000 participants under a twenty-five-option assumption. In other words, by providing its employees with a large number of investment options, Deere effectively excluded 3,000 to 8,000 employees from its plan,[85] and reduced its ERISA liability risk by doing so.

The wealth reduction caused by large menus is staggering, primarily because nonparticipation deprives employees of the company match. About 85% of plan sponsors make matching contributions to defined contribution plans.[86] The most common match amount is either 50% or

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[82] A 2009 survey by Watson Wyatt found that the most common number of options in 401(k) plans was ten to fourteen, with 11% of plans offering more than twenty-four options. *SeeNews Archives – August / September 2009*, BENEFITS AND PENSIONS MONITOR ONLINE,http://www.bpmmagazine.com/benefits_news_august_september_2009.html (last visited Apr. 3, 2014).

[83] Second Am. Compl. for Breach of Fiduciary Duty at para. 28(a), Hecker v. Deere & Co., No. 06-C-0719-S (W.D. Wis., Mar. 6, 2007) 2007 WL 2891544, at *8.

[84] If 30,000 participants equaled a 61% or a 68% participation rate, then a 75% participation rate would equal, respectively, 36,885 and 33,088 participants (.75*(30000/.61) and .75*(30,000/.68)). The participation rate estimates in this section are extrapolated from the Columbia analysis for illustrative purposes. They are not intended to reflect actual rates, which are generally available in a company's Form 5500 filings.

[85] Exelon's large menu probably had a similar effect. Approximately 23,000 Exelon Corp. employees participated in its thirty-two-option retirement plan, which, assuming a large-menu-suppressed 68% participation rate, means that 2,000 fewer employees participated than likely would have participated in a two-option plan. *See* Compl. for Breach of Fiduciary Duty at para. 27(a), Loomis v. Exelon Corp., No. 06CV4900 (N.D. Ill.., Sept. 11, 2006), 2006 WL 2791653 (23,000 participants in Exelon plan).

[86] *See* AON HEWITT, 2011 TRENDS AND EXPERIENCE IN DEFINED

100% of employee contributions up to 6% of their pay.[87] Deere offered a maximum 401(k) match of 6%,[88] which means that for every $1 contributed by an employee up to 6% of their pay, Deere contributed $1 to the employee's 401(k) account. For a Deere employee earning $25,000 annually who contributed 6% of his pay to Deere's 401(k) plan, the 6% match would represent $1,500 in additional annual income. The Deere employee who does not participate in the 401(k) plan receives none of this additional income. Assuming Deere's large menu effectively excludes 3,000 to 8,000 employees from its plan, these employees lose $4.5 to $12 million in income *every year*, even before taking into account lost investment gains.

By offering a large menu, Deere reduces not only its ERISA liability risk, but also its compensation expenses. The $4.5 to $12 million of foregone annual income directly increases Deere's profits. This means that the Seventh Circuit's assumption that employers do not have a conflict of interest in the design of their 401(k) plans is actually false.[89] Employers can increase their profits by increasing the size of their 401(k) menus because

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CONTRIBUTION PLANS 4 (2011), *available at* http://www.aon.com/attachments/thought-leadership/2011_Trends_Experience_Executive_Summary_v5.pdf.

[87] *See id.*

[88] *See* Hecker v. Deere & Co. 556 F.3d 575, 579 (7th Cir. 2009).

[89] *Loomis*, 658 F.3d at 671 (Exelon "had (and has) every reason to use competition in the market for fund management to drive down the expenses charged to participants, . . . Competition thus assists both employers and employees, as Hecker observed."). It is hard to take this distinction seriously, as Judge Easterbrook made the same argument in Jones that a fund manager has the same market-based incentive to keep fees low:

> Holding costs down is vital in competition, when investors are seeking maximum return net of expenses—and as management fees are a substantial component of administrative costs, mutual funds have a powerful reason to keep them low unless higher fees are associated with higher return on investment. A difference of 0.1% per annum in total administrative expenses adds up by compounding over time and is enough to induce many investors to change mutual funds. That mutual funds are "captives" of investment advisers does not curtail this competition. An adviser can't make money from its captive fund if high fees drive investors away.

Jones v. Harris Assocs. L.P., 527 F.3d 627, 631-32 (7th Cir. 2008).

that will result in fewer employees taking advantage of the employer match. The employer will still be able to attract workers by advertising employee compensation as including a 6% match. This cause-and-effect relationship is, of course, somewhat attenuated, but it is useful in illustrating the absurd position in which the large menu defense courts have placed employers.

In contrast with Deere's being rewarded for its large menu, Wal-Mart was punished for offering a limited menu that, precisely because it is limited, creates billions of dollars of wealth for its employees.[90] The Wal-Mart plan offered eleven investment options and had approximately one million participants, which would represent a 70% participation rate under the Columbia analysis. If Wal-Mart had offered fifty-six options, its plan's predicted participation rate would have been 61%, which translates into approximately 130,000 fewer employees participating in the plan. Wal-Mart offers a full match up to 6% of the employee's pay, which for 130,000 employees earning $25,000 annually would total approximately $2 billion over ten years, even before taking into account investment gains. Thus, Wal-Mart employees' wealth has been increased by billions of dollars because Wal-Mart's plan has a limited menu of options. The large menu defense creates an incentive, however, for Wal-Mart to increase the number of options in its plan in order to reduce its ERISA liability exposure. If Wal-Mart decides to follow the guidance of the courts which support the large menu defense, then its workers will be billions of dollars poorer as a result.

The adverse effects of large menus are most pronounced for the groups who stand the most to lose by not participating in 401(k). The Columbia researchers found that the reduction in participation rates caused by large menus was even greater for older workers, female workers and low-income workers.[91] These are the groups for whom inadequate investing for retirement will have the direst consequences. Older workers have less time to put away funds for retirement, females live longer and therefore have longer retirements to plan for, and low-income workers have the greatest need for each additional dollar of income in retirement. The

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[90] Braden v. Wal-Mart Stores, Inc., 588 F.3d 585, 603 n.6 (8th Cir. 2009); *see* Ruppert v. Principal Life Ins. Co., 796 F. Supp. 2d 959, 963 (S.D. Iowa 2010) (citing argument that limited menu in *Braden*, compared with large menu in *Hecker*, made imprudent management claim more plausible); Tibble v. Edison Int'l, 711 F.3d 1061 (9th Cir. 2013).

[91] Iyengar & Jiang, *supra* note 80, at 16.

disproportionate effect of large menus on these groups will impose greater financial burdens on society as well because reduced standards of living in retirement will inevitably place greater pressure on our already strained Social Security system.

B. LARGE MENU EFFECTS – OVERLY CONSERVATIVE ALLOCATIONS

The losses attributable to large menus are by no means limited to lower participation rates. The Columbia study found that large menus also harm participants by causing them to make overly conservative allocations of their assets. This finding is consistent with general research showing that increasing choice suppresses risk-taking. For example, in one study, researchers asked subjects to choose from a series of hypothetical salary options. The researchers found that the subjects' willingness to take risks was inversely correlated with the number of options offered. Similar studies have shown that subjects are more likely to make worse decisions as the number of options increases. For example, a 1995 study found that doctors, when offered the option of prescribing either of two medicines for a medical condition, each of which would have been an improvement over doing nothing, usually chose to do nothing.[92]

These responses to increasing the number of choices were similarly reflected in plan participants' allocation decisions. The Columbia researchers found that, for every ten-option increase in the size of the menu, participants' allocations to equity funds decreased by 7.1 to 8.9 percentage points, "an amount both economically and statistically significant (at the 2.5% level)."[93] This reduction in equity fund allocations is not nearly as striking as the increase in participants who allocated none of their contributions to equities. The researchers found that "the

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[92] *See* Donald A. Redelmeier & Eldar Shafir, *Medical Decision Making in Situations That Offer Multiple Alternatives*, 273 J. AM. MED. ASS'N. 302 (1995), *available at* https://psych.princeton.edu/~psych/psychology/research/shafir/pubs/JAMA.pdf.

[93] *See* Iyengar & Jiang, *supra* note 80, at 30; *see also* Sheena S. Iyengar & Emir Kamenica, *Choice Proliferation, Simplicity Seeking, and Asset Allocation*, 94 J. PUB. ECON. 530 (2010) (finding that when a correlation is statistically significant at the 2.5% level, there is a 2.5% chance that a correlation is the result of chance).

probability that an individual contributes anything at all to equity funds also drops by 3.1-4.6%, significantly different from zero at the 5% level."[94]

Conversely, a ten-option menu increase resulted in "3.9% and 5.4% increases in contribution allocations to, respectively, money market funds alone and both money market and bond funds combined."[95] Each ten-option menu increase also produced "nearly a 2% increase in the percentage of choosers who allocated over half their contributions to money market funds alone, and a 3.6% increase in the percentage of choosers who allocated over half their contributions to money markets and bonds combined."[96] This shift of assets to less volatile classes would make sense for older workers, but the researchers found that the effects of large menus were uncorrelated with age or job tenure. These effects were greater, however, for female workers and low-income workers,[97] for whom the adverse effects of inadequate retirement preparedness are also greater.[98]

These large-menu effects impose substantial opportunity costs on plan participants. The expected value of a twenty-year investment in equities, which is an appropriate investment period in light of the increased risk of equity investments, is substantially higher than the expected value of a twenty-year investment in bonds or money market instruments. This problem of overly conservative investment options was a concern for the

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[94] *See* Iyengar & Jiang, *supra* note 80, at 30. This tendency may be countered if the percentage of equity funds grows with the size of the menu because investors tend to increase their allocations to a particular asset class in proportion to that asset class's representation in the menu. *See* Shlomo Benartzi & Richard H. Thaler, *Naive Diversification Strategies in Defined Contribution Saving Plans*, 91 AM. ECON. REV. 79, 87 (2001) (finding that when equity options comprised a larger percentage of hypothetical options, study subjects invested a larger percentage of accounts in equities than when equity options comprised a smaller percentage of options), *available at* http://www.anderson.ucla.edu/documents/areas/fac/accounting/naive_diversification.pdf; *see also* Jeffrey Brown et al., *Individual Account Investment Options and Portfolio Choice: Behavioral Lessons from 401(K) Plans* (NBER Working Paper, No. 13169, June 2007) (increasing equity fund representation from 1/3 to 1/2 of menu increased participants' equity allocations by 7.5%) ("*Behavioral Lessons*"), *available at* http://www.nber.org/papers/w13169.pdf?new_window=1; Karlsson et al., *supra* note 46 (likelihood of option being chosen increases with its representation in menu), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=888661.

[95] *See* Iyengar & Jiang, *supra* note 80, at 33-34. .

[96] *Id.*

[97] *Id.* at 31.

[98] *Id.* at 16.

DOL in 2006, when it was considering the kinds of investment options to which employers should allocate contributions of participants who provided no instructions. Stable value fund sponsors lobbied the DOL to include such funds as "qualified default investment alternatives," but DOL wisely rejected their entreaties. Its decision to encourage more appropriate risk-taking by participants contrasts with the large menu defense's effect of arbitrarily reducing risk-taking by encouraging larger menus. The large menu defense similarly undermines the 2006 legislative reform that permitted automatic enrollment of employees in 401(k) plans and has substantially increased plan participation rates. On both fronts, the large menu defense courts are effectively undoing the demonstrated benefits of regulatory reforms.

C. LARGE MENU EFFECTS – INFERIOR INVESTMENT OPTIONS

In addition to reducing participation rates and causing overly conservative asset allocations, large menus reduce the quality of the investment options in 401(k) plans as a group. Researchers have found that the quality of the funds in a plan declines as the number of options increases.[99] David Goldreich and Hanna Hałaburda studied 131 401(k) plans with the number of investment options offered ranging from four to twenty-eight. They evaluated the objective quality of the plans by comparing their respective Sharpe ratios, which measure expected investment return in light of the degree of risk taken by the investor. The data showed a negative correlation between the number of investment options offered and the quality of the plan that was significant at the 1% level. Like the Columbia group, Goldreich and Hałaburda concluded "empirically that larger menus are objectively worse than smaller menus, on average, in an important economic context—401(k) pension plans, where a plan is a menu of investment choices."

Along the same lines, Nina Tang and Olivia Mitchell found that increasing the number of investment options offered in a 401(k) plan did not increase the efficiency of the menu. They evaluated efficiency based on each plan's Sharpe ratio, degree of nondiversifiable risk, and participants' potential welfare/utility loss resulting from a less efficient menu.[100] They concluded that, "even with a handful of investment choices,

[99] *See* Goldreich & Hałaburda*, supra* note 3, at 1.

[100] Ning Tang & Olivia S. Mitchell, *The Efficiency of Pension Plan Investment Menus: Investment Choices in Defined Contribution Pension Plans* (Mich. Ret.

participants will not suffer from menu restriction, as long as the choices offered are sensible ones."[101] They found that it would be "more sensible to add funds that make the menu more efficient, than simply to make the menu longer,"[102] which is precisely the intent of the three-option and broad-range diversification safe harbor requirements.[103] "The key factor contributing to plan efficiency and performance has to do with the types of funds offered, rather than the total number of investment options provided."[104]

Larger menus are also correlated with higher cost options.[105] Researchers have found that, as the size of a 401(k) plan's menu increases, the representation of actively-managed funds increases at a greater rate. Actively managed funds charge higher fees than index funds, which means that larger menus correlate with higher costs. The higher fees also mean that large menus have inferior performance. The researchers found that, while the gross performance of index and actively-managed funds was similar, their relative performance net of fees was quite different, with index funds substantially outperforming in terms of both investment returns and percentile ranking.[106] Thus, large menus are correlated with inferior, higher-cost, lower-performing investment options and provide no efficiency benefits.

D. LARGE MENU EFFECTS AND INFORMATION OVERLOAD

The foregoing empirical research demonstrates that rational choice theory fails in the context of large 401(k) menus, notwithstanding the faith that courts in favor of the large menu defense have in the infallible

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Res. Ctr., Working Paper 2008-176, No. UM08-20), *available at* http://www.mrrc. isr.umich.edu/publications/papers/pdf/wp176.pdf.

[101] *Id.* at 7.

[102] *Id.* at 16.

[103] *See* 29 C.F.R. § 2550.404c-1(b)(3)(i)(B)(1-4).

[104] Tang & Mitchell., *supra* note 100, at 2.

[105] *See* Brown et al., *supra* note 47, at 2.

[106] *See id.* at 26 ("while the actively managed and index equity funds offered in our sample of 401(k) plans have similar performance before accounting for expenses (index funds actually slightly outperformed, but the difference is not significant), they differ significantly in their reported annual expenses (on the order of 50 basis points per year), which leads to worse performance after accounting for expenses (both in terms of returns and percentile rankings within its investment objective.)").

efficiency of "rational" actors and free markets. Large menus cause employees to make worse choices either by making inferior asset allocation decisions or by not participating in 401(k) plans at all. Large menus also result in inferior options being selected by employers. One explanation for investors' behavioral response to large menus is information overload and complexity, which is particularly ironic in the context of the free market ideology underlying the large menu defense. That ideology assumes that investors are better off with large menus because it is more likely that the menu will include, for example, a low-cost fund. As the *Loomis* court argued, "[a]ny participant who want[ed] a fund with expenses under 0.1% can get it through Exelon's Plan."[107] However, the fact that a large menu may be more likely to include such a low-cost fund misses the point. The evidence suggests that an investor would be less likely to actually *find or invest in* the 0.1% fund precisely because it was part of a large menu.

Researchers have found that search costs are a significant factor in the depressing effect of large choice sets on consumers' willingness to make choices.[108] The additional search costs that a large menu of investment options imposes may lead investors not to search at all (*i.e.*, not participate), or to favor the simplest options, such as money market and bond funds.[109] They may be more likely to follow irrational heuristics, such as making an allocation to equity investments based on the percentage of equity options offered.[110] Large menus that impose high search costs make it less likely that investors are actually exercising the "control" that is the basis of the control safe harbor because they will be deterred from exercising control by search costs, yet courts employing the large menu defense assume that larger menus lead to the exercise of greater participant control. In fact, investors may be more likely to avoid an excessive fee fund that is included in a small menu rather than a large one because they are more likely to seek out information about a small number of funds than

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[107] *Loomis*, 658 F.3d at 671.

[108] *See generally* Dmitri Kuksov & J. Miquel Villas-Boas, *When More Alternatives Lead to Less Choice*, 29 MKTG. SCI. 507 (2010), *available at* http://groups.haas.berkeley.edu/marketing/PAPERS/VILLAS/Marketing%20Science%202010%20alternatives.pdf; Julie Agnew & Lisa Szykman, *Asset Allocation and Information Overload: The Influence of Information Display, Asset Choice, and Investor Experience*, 6 J. BEHAV. FIN. 57 (2005) (showing that study subjects reported greater feeling of information overload with more choices) *available at* http://mason.wm.edu/faculty/agnew_j/documents/assetallocation.pdf.

[109] Kuskov & Villas-Boas, *supra* note 108, at 512.

[110] *See* Brown et al., *supra* note 47, at 18.

when intimidated by a large number. As one research team concluded, "the burgeoning number of actively-managed funds [in large 401(k) menus] makes it harder for investors to find the lower-cost index fund in the plan."[111] In other words, investors are less likely to conduct the information search necessary to identify the low-cost needle when included in a large menu haystack.

V. CONCLUSION

The law and economics movement was the most influential jurisprudential development of the 20th century. The application of economic principles to traditional legal concepts has substantially improved our understanding of the relationship between law and practice. In no field has this been truer than in the regulation of commercial activities. Law and economics has improved our ability to apply traditional notions of equity, such as good faith and fair dealing, unconscionability, and fiduciary duties, in ways that better achieve their utility-maximizing purpose.

However, law and economics, especially in the hands of judges, can be an instrument of economic destruction when based on blind adherence to a free market ideology unmoored from any empirical foundation. The large menu defense adopted by some courts applies an axiom of free market adherents—rational choice theory—the social utility of which is disproved by empirical research on the actual effect of large 401(k) menus on workers' welfare. Large 401(k) menus already cost American workers billions of dollars every year. The effect of the large menu defense, unless promptly repealed by Congress or overturned by the Supreme Court, will exacerbate the problem of large 401(k) menus and cause billions of dollars of additional losses.

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[111] *Id.* at 25.