401k plans have become one of the most popular forms for investing in employee retirements, while traditional pension plans are now starting to become a thing of the past. Employers are more geared to the 401k plans because it takes a major responsibility off of the company, and puts it onto the employee. Now more and more people are forming a 401k plan for their retirement, however a number of people have unknowingly opened the gates up to an exurbanite amount of risk. A total of 20,795 Enron employees have found themselves in this situation, which they were wrongfully mislead into believing that their investment was going to be profitably. Could the employees now be paying the price for a situation that could have been prevented?

WHAT IS A 401K?

A 401k plan is a plan set up by the employee, which sets aside a portion of their income each month and it becomes invested into areas such as individual stock, mutual funds, and money market accounts.\(^1\) Usually the company will also match your contributions by some percentage. Enron’s matching system matched up to approximately 3% of their annual income with company stocks.\(^2\) One of the best aspects about the 401k Plan is that the money invested is not taxed, meaning no income tax is paid on the employee’s contribution or the employer’s contribution. This gives incentives for employers and employees to invest, and in fact 38 million people in America do actually take part in a 401k plan.\(^3\)

\(^1\) http://moneycentral.msn.com/quickref.asp?Cat+10&SelCat=6&RefType=O&AMODE=1&QID=277&Topic=O&Sub=
\(^2\) http://proguest.umi.com/pqdweb?Did=000000112705862&Fmt=4&Deli=1&Mtd=1&Idx=27&Sid=4&RQT=309
The unpopular traditional pension plans of today, was the main form of retirement planning before the 401k plans. Pension Plans allowed employees who stayed loyal with a company for a number of years and would continue to receive pay from the company after retirement. The employee would contribute much like a 401k plan however the amount at retirement was predetermined (fixed), unlike the 401K plans. Few people had these types of plans because they did not stay with a company for a long period of time; inevitably many people would then have to work past a normal working life. Especially with the current trends for people to move through many careers during their lifetime, it has become a poor form of planning for retirement. The 401k Plan is quite different because it moves around with the employees no matter where they work, allowing the fund to continue growing.

Many people become very reliant on their 401k plans hoping that by the age of 59½, when they can withdrawal from their retirement fund, that it will support them. In the case of Enron, thousands of employees had been placing money into their retirement fund to one day be able to relax and enjoy life without work. However by ignoring the risks, employees have lost their entire life savings and could possibly be spending the rest of their life on the job.

**ENRON SCANDAL**

Enron supposedly deceived the investors with the help of Arthur Andersen by concealing the facts that Enron was losing profits. They continuously told the employers and other investors that Enron was strong and growing company, while it is currently trying to be proven in court, that Enron officials and Andersen were watching the
company go under. Investors had reason to believe Enron’s success, especially when shares hit $90 dollars a share. Kenneth Lay, the CEO of Enron, after having just said that the third quarter in 2001 was looking great, reported two weeks later on October 16, 2001 that the Company had a $618 million third quarter loss.\textsuperscript{4}

This took investors by surprise because no one expected this to happen. The employees were left with literally no retirement. To make matters worse the day after the disastrous announcement, Enron supposedly proceeded with a scheduled blackout period to change the 401k’s administrators. The investors were stuck with the fate of the stocks because they were not allowed to divest during October 17\textsuperscript{th} thru November 20\textsuperscript{th}, 2001. Investors sat helplessly while the stock plummeted to 67 cents per share where it was then delisted from the New York Stock Exchange. Then the investors later found out that the blackout period was supposedly delayed for one week, which could have saved them a major portion of their retirement.\textsuperscript{5}

**THE AFTERMATH**

As a result, the outcome has been total devastation to anyone involved in the scandal. Employee’s retirements have been completely lost. In a particular example, a husband and wife who planned for retirement this coming June 2002 had to put it off since Enron has filled for bankruptcy. Their 401k plan went from $615 thousand to $11 thousand after the announcement. Having faith in the company that he had worked for, they put 90% of his savings into company stock. This man, Mr. Padgett said, “Upper management actively encouraged us to invest in Enron. They were predicting shares of

\textsuperscript{4} http://www.enronsuit.com/press.html
\textsuperscript{5} http://www.enronsuit.com
$100 to $120 by February. We were looking for the best return; we thought it would be foolish not to do it.” Now they are faced with starting over and their dreams of retirement are shattered.⁶

REFORM

Legally there is no law that protects the investors by capping the amount of shares to be purchased in one company. Smart investors would never invest more 10% of the same stock according to the Employee Benefit Research Institution.⁷ Diversification of the stocks is the best way to prevent against such catastrophes as Enron. A number of investors had more than 60% of their stock in the Enron Corporation and as a result the total loss was well over one billion dollars.

Lawmakers are vigorously trying fill in a loophole, which occurred in 1974 when the federal Employee Retirement Income Security Act (ERISA) was made. This Act allowed for an unlimited amount of shares to be invested in one company. Now the Congressman has just passed a bill last April 2002, which will hopefully give more protection to the investors. The bill included allowing 401k plan participants to sell their stock that were matched to them by their employer after a three year time period. Enron forced its employees to hold their matched stocks until they reached the age of 50, essentially making them untouchable.⁸ The bill also included giving employees plenty of notice of any blackout and also stopping top executives from selling shares they hold outside the plan during the blackout. Finally, other provisions of the bill would require that employers improve their investment education. By allowing plan participants to use

⁷ http://www.retirement-4-u.com/401k_Planning/401k_planning .html
pretax dollars to purchase investment advice, this would help investors alleviate part of the risk involved in investing in 401k plans by giving the employees a better knowledge of their investments.\(^9\) This bill will help to protect the innocent people who do not fully understand the magnitude of the risks and hopefully these types of major losses will not occur again.

**WHO'S TO BLAME?**

Betting your money in the stock market is risky and the liability essentially is left up to the investors. But when secrets are kept from the shareholders and misinformation is given to them then the liability should shift to the wrong doers. Some risk still does ly in the hands of the investors however had their been preventative measures to control such situations then we may not have seen such a huge crises as we do today. Also lawsuits have now formed against the Enron Corporation and Andersen accounting firm. The plaintiffs (the employees) are suing for the lost damages in their 401k plans.

**FUTURE PREVENTION**

There is many ways that the Enron 401k situation could have been prevented if simply the employees had a clearer understanding of how to invest. Many investors stay with their company stocks because they feel more comfortable. Also, the fear of purchasing a stock that they have no knowledge of seems riskier than have all their eggs in one basket. Some companies like Enron promote their employees into investing a large portion of the stocks into their 401k plans because they believe that it will make the

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employees more loyal to the company. By having a large interest in the company that they work for, the employees will work harder to protect their assets. The problem in this situation when an Enron mishap occurs, employees have not only lost their entire investment they have also lost their job. Simple tips such as diversifying, and rebalancing could have saved the Enron employees from a huge loss.

Enron employees simply ignored the rule of diversification. Many invested into the company stocks, which made up over 60% of their portfolio. When leaving the retirement investing in the hands of the individual workers, lawmakers have forgotten the importance of further regulations to protect the people who misunderstand the basics behind investments. Diversification is a key tool in balancing out the ups and downs of the economy and can save your retirement when companies like Enron fold.

Age of the individual also plays a key role in the terms of their 401k plans. The example used early with the husband and wife who has lost most of their retirement had at least 90% of their money invested in Enron stocks. The closer the person gets to retirement the more funds should be put into a safer investment. Money markets and bonds are generally the safer route for your funds but it brings in a fairly low return making it seem less attractive. Enron employees were encouraged seeing the stock grow at a rapid rate that they ignored the basic rules of a sturdy 401k plan.

If we were to look back at the mistakes made by the Enron employees with respect to their 401k plans, it would be evident that they simply did not understand how to manage an effective portfolio. They got distracted by the possibility of making millions, and forgot about the amount of risk involved. Enron employees are not the only ones uneducated about holding a 401k plan, it has been studied that in the year 2000 30%
of plan participants did not make any type of asset transfers in their 401k plans. Also after the news of Enron only 27% of those surveyed by Charles Schwab thought it was important to diversify.¹⁰

**WHAT CAN BE LEARNED**

Nobody could have predicted that the Enron Corporation would be bankrupt and employees facing these horrific investment losses. Everyone, not just the employees, have felt the impact of this scandal in one way or another, whether it just be the fear of what could happen to them. 401k plans are a very risky gamble that most are willing to pay when the odds are in your favor. Simple protective action can be taken to ensure a safer portfolio. It must first begin with an understanding of the risk and potential loss that can occur. Next, following general guidelines such as diversifying, making sure not to put more than 10% of your overall investment into any one company, and rebalancing your portfolio at least yearly. Had the Enron employees dealt with their risk a little more wisely, we could have prevented this situation even with Enron’s bankruptcy. Employees would have undoubtedly seen a dropped in their in 401k investment but nowhere near this magnitude, had they been more risk conscientious.

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¹⁰ “Getting Personal: Mental Shortcuts With 401Ks Are Risky”, By Jane J. Kim, WSI, April 12, 2002.