# COMMENT
# PENSIONS AND PASSIVITY

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Professor Alexander is justifiably critical of the "pension-fund socialism" thesis.[1] The notion that, because pension plans have become the owners of a major portion of U.S. corporate equity and debt, there is some form of unseen socialist revolution is nonsensical. If life insurance companies owned these same assets, there would be no talk of socialism, yet the effect would be similar. The mere fact that one is the beneficiary of an annuity, life insurance policy, or a pension plan does not make one the owner of the underlying assets that generate the wealth necessary to make the payments thereunder.

Socialism is a deeper concept than mere ownership. Even if all the pension plans and financial intermediaries were eliminated, and all corporate stock were somehow nationalized and distributed equally to every citizen, the present system would change little. The separation of ownership from control, in the Berle and Means sense,[2] would remain. Such diffuse ownership would leave corporate managers even more unfettered than they are today, when at least some financial intermediaries, especially public pension funds, have become more active in reviewing management.[3] This is a widely recognized contemporary problem, but it has little to do with pensions.

Classical socialism is the utopian Marxist vision of direct worker ownership of the means of production. The workers control the factory in which they work or, certainly, at least the company that employs them. Professor Alexander sees some type of workplace democracy as a means whereby workers can protect themselves against plant closings, job relocations, wage reductions, and the like. One can certainly be skeptical about worker ownership providing enhanced protection against the general insecurities of the modern global marketplace, but the main problem with focusing on workplace democracy is that it is fundamentally unrelated to the issue of pension policy.

Professor Alexander views pension plans as a device for achieving workplace democracy. The plan can simply buy the company, or at least enough of it to obtain a strong voice in corporate affairs. This "voice" would then be passed to the plan participants, who would steer the plan fiduciary in some democratic

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1. *See* Gregory S. Alexander, *Pensions and Passivity*, 56 LAW & CONTEMP. PROBS. 113 (Winter 1993).

2. *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

3. *See, e.g.*, Kevin G. Salwen & Joanns Lublin, *Activist Holders, Giant Investors Flex Their Muscles More at U.S. Corporations*, WALL ST. J., Apr. 21, 1992, at A1.

fashion. Pension funds certainly could be used in this manner, but nothing inherent in the nature of a pension fund links it to worker ownership. Consider the numerous workers employed by the nonprofit institutions in our society, such as universities and hospitals, as well as the federal, state, and local governments. How could such workers possibly invest in their employers? The only connection between pension funds and worker democracy is that workers interested in buying their employer need money, and pension funds have money. But one could imagine other ways to gain control over an employer. For example, if a group of managers can arrange a leveraged buyout of their company and take it private, in principle the employees could do the same, at least if potential lenders were convinced that the employees could be profitable managers.

Professor Alexander's central thesis is that there is a powerful link between property ownership and responsibility (both individual and civic). Owning property compels individuals to manage it and to confront the consequences of their decisions regarding the use of property. It requires the owner to become responsible. For this reason, the passive form of ownership created by the pension system, and especially defined benefit plans, diminishes the highly desirable degree of personal responsibility that classical property ownership demands.

In my view, there is great danger in basing dramatic changes in retirement savings policy, changes that could affect the economic security of millions of workers, on rather abstract philosophical notions. The tragic history of Marxism is a powerful lesson in the risks presented by utopian visions of the relation between people and society.[4] My own brief, and admittedly anecdotal, exposure to humankind suggests that a substantial amount of property is neither a necessary nor a sufficient condition for responsibility. There are plenty of responsible people with modest amounts of property and plenty of irresponsible people with large amounts. The personality traits that lead to civic virtue are probably developed as a child and adolescent, in most cases long before significant amounts of property are acquired.

One can accept Professor Alexander's argument that active property ownership promotes individual self-governance, but at the same time recognize that for sound reasons of public policy that are democratically determined, certain rights will be possessed in a more passive fashion. If citizens were completely dispossessed of active property ownership, as is largely the case in state socialist regimes, one could certainly predict a stunting of civic virtue and individual initiative and responsibility. But given a background regime that

4. "The Russian intelligentsia never seriously fought for sausage for the people, instead it fought for their 'liberation'; and that is being repeated today. Abstract thinking prevailed. The intelligentsia would not agree to less than salvation, and as a result Russia has nothing—neither salvation nor sausage." Viktor Erofeev, *Neither Salvation Nor Sausage*, N.Y. REV. OF BOOKS, June 14, 1990, at 23, 25.

generally aspires to free markets and active property ownership, the carving out of limited passive spheres hardly seems to present serious social risks.

It is difficult to understand how most workers are meaningfully diminished because their employers provide them with a pension, or even because the government provides them with social security. The thought that, after years of hard work, a pension, perhaps even a guaranteed one, awaits, is in many ways liberating. Now it is true that wages would be higher without these benefits, and the workers would be free to consume or invest these funds. But a rational worker would save for retirement, and a rational small investor saving for retirement would invest in a diversified portfolio. Attempting to construct such a portfolio through selective investing would lead to below-market returns due to the increased transaction costs. Our rational worker would then be led to invest in mutual funds, a highly passive investment.[5] If modern portfolio theory[6] makes passive investing the rational choice for retirement saving, how much harm is truly being done by compelling such passive investing in the form of pension benefits?

After a discussion of some rather serious countervailing considerations, Professor Alexander nevertheless concludes his article with a plea for greater employee "voice" in plan investment decisions. There are two major problems with his proposal. First, such "voice" in connection with defined benefit plans (in contrast to defined contribution plans) is inappropriate, largely because it would give employees some control over property that is not really theirs, a result more likely to lead to irresponsibility. Second, "voice" has the potential to compromise another important social goal—retirement income security.

Turning to the first problem, the property rights of a plan participant depend on the nature of the retirement plan. In the case of a defined contribution plan, an individual account exists for each participant. The employer makes periodic contributions to the plan, a portion of which is allocated to each participant. The account is credited with its share of gains and losses and is charged with its share of expenses. The participant's benefit is that which is in the account.

In the case of the defined benefit plan, no individual accounts exist. There is simply the promise of a future benefit, usually determined ("defined") by some formula set forth in the plan. The actual assets in the trust used to fund the plan do not determine the benefits. The assets could double in value and not affect the participants' benefits at all. In such plans, the assets in the trust resemble assets pledged to secure an obligation. They increase the likelihood that the promised benefits will be paid. Of course if a plan is overfunded, there may be

5. For a discussion of the implications of the efficient market hypothesis for investment policy, see ZVI BODIE, ALEX KANE & ALAN V. MARCUS, INVESTMENTS 345-49 (1989). Those authors state, "The small investor is probably better off placing funds in a mutual fund." *Id.* at 348.

6. Modern portfolio theory suggests that active management can be justified only when an investor possesses a measurable degree of predictive ability and can efficiently translate that ability into investment actions. *See* ROBERT L. HAGIN, MODERN PORTFOLIO THEORY: THE DOW JONES-IRWIN GUIDE TO MODERN PORTFOLIO THEORY, 217-25 (1979). The typical employee will not have these skills.

a greater probability that the employer will be willing to increase benefits, but this is still a matter of employer choice.

If the assets are invested poorly, or the rate of return is less than expected, the employer will have to make up the shortfall by contributing more to the trust. The Employee Retirement Income Security Act of 1974 ("ERISA")[7] imposes liability on the employer, and even certain related employers, for any shortfall.[8] If the assets perform exceptionally well and achieve a rate of return greater than expected, the employer benefits by being able to reduce future contributions. The employer may even be able to terminate the plan and recover any surplus, although Congress has severely discouraged this practice by imposing a fifty percent excise tax on such reversions.[9] As Fischel and Langbein have pointed out, the employer's interest in the plan is such that it is sensible to think of the employer also as a beneficiary of the plan.[10]

If, due to insolvency or bankruptcy, the employer is unable to make up a shortfall in plan assets, the Pension Benefit Guarantee Corporation ("PBGC") will cover the promised benefits, up to a statutory maximum.[11] Thus, the PBGC is an insurer of plan benefits and is vitally interested in proper trust investment so that its risk of having to pay on its guarantee is as low as possible.

Why should employees have a major voice in how the defined benefit plan's funds are invested? If below-market returns are received because investments are targeted to certain firms or communities or are simply mismanaged due to mistaken investment choices, it is the employer in the first instance, and then the PBGC, who must pay, not the workers. The PBGC currently insures the payment of defined benefits up to $2,352 per month,[12] far beyond the average pension.[13]

Professor Alexander argues that employees do bear a significant risk because underfunding is a major problem. Though underfunding is a major problem, it is limited to a small group of firms, concentrated mainly in a few industries. The vast majority of plans are adequately funded.[14] The list of industries with significant concentrations of underfunded plans is instructive; primary metals (steel, for example) and transportation equipment (automobiles, for example)

7. Employee Retirement Income Security Act § 4062, 29 U.S.C. § 1362 (Supp. II 1990). The Act is codified at 29 U.S.C. §§ 1001-1461 (1988).

8. 29 U.S.C. § 1362.

9. I.R.C. § 4980 (1988). If the employer establishes an appropriate replacement plan or provides a certain level of increased benefits to the participants, the excise tax drops to 20%. *Id.*

10. Daniel Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105, 1117-19 (1988).

11. 29 U.S.C. § 1322 (Supp. II 1990).

12. 56 Fed. Reg. 64,985 (1991) (to be codified at 29 C.F.R. § 2621, Appendix A).

13. In 1987 the average annual retiree benefit was $5,200. U.S. DEPARTMENT OF LABOR, PENSION AND WELFARE BENEFITS ADMINISTRATION, TRENDS IN PENSIONS 13 (1989).

14. "From 1974 to 1985 the percentage of plans achieving fully funded status more than doubled from 35 to 73% based on termination liabilities calculated from the plan's own actuarial assumptions. Moreover, in 1985 the assets held by plans were 116% of total liabilities on a termination basis." *Id.* at 125.

account for a major share of the underfunding.[15] Consider how much worse the underfunding (and the corresponding government liability) would have been if these plans had heavily invested in their own sponsors. In any event, what underfunding does exist is, as noted above, primarily a problem for the PBGC. The average pensioner will not lose anything. To provide employees with control over plan investments in a defined benefit plan is to allow them to play with other people's money.

An international comparison is instructive. In Germany, the most common type of pension is an unfunded defined benefit plan.[16] The liability to the participants is carried on the employer's books, but no assets are set aside in trust or earmarked in any way. The German equivalent of the PBGC insures the promise up to a certain level.[17] What the participants own is a contractual right to future payments. There is no fund over which it can be sensibly said that the participants deserve some control. In reality, our system is not much different, except that the managers of the PBGC can sleep better at night knowing that there are earmarked funds in a trust, thereby reducing the probability of loss to the PBGC.

Although Professor Alexander seems hostile to defined benefit plans because of the inevitably passive nature of the employees' property rights, such plans have important and unique benefits regarding retirement security. First, because employees are compelled to participate as a group, the annuity is fairly priced. The cost depends on the average life expectancy of the group. If a participant sought an equivalent annuity from a private insurer, it would be more expensive. The reason is self-selection. People who are ill, or for one reason or another (family history of disease or early death) expect to die earlier than the average person, tend to view annuities as a bad investment. Thus, purchasers of private annuities tend, on average, to live longer than the general population. Insurers must price their products accordingly.

A second advantage of defined benefit plans is risk spreading. A defined benefit plan can afford to invest in a riskier portfolio because its investment horizon is not one lifetime but indefinite. For example, suppose one is a few years away from retirement. Would it be prudent to buy a thirty year bond or a risky start-up company? One tends, sensibly, to invest more conservatively to avoid sharp wealth changes as one approaches retirement. But the defined benefit plan need never become conservative. Because of its longer time

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15. *Id.* at 150, tbl. 8.6. In 1985, "83 percent of the total amount underfunded was concentrated in only 3 of the 11 major industries." *Id.* at 142. Most of the PBGC's deficit is attributable to a handful of large claims. The 12 largest claims against the PBGC account for 76% of the claims through 1986. Almost 80% of these claims are attributable to the decline of the steel industry. *See* RICHARD A. IPPOLITO, THE ECONOMICS OF PENSION INSURANCE 42-43 (tbl. 3-2) (1989).

16. *See* Bruce A. Wolk, *Taxation of Unfunded Deferred Compensation: A Comparison of the Federal Republic of Germany and the U.S. Systems*, 6 INT'L TAX & BUS. LAW., Winter 1988, at 1, 2.

17. All such plans must meet certain minimum requirements of German labor law. The relevant statute is the Gesetz zur Verbesserung der betrieblichen Altersversorgung [BetrAVG] of December 19, 1974, 1974 Bundesgesetzblatt, Teil I [BGBl I] 3610, as amended.

horizon, the defined benefit plan can invest in a riskier, and thereby more diverse portfolio, which, according to modern portfolio theory, will produce a higher average rate of return.

If, as I have argued, defined benefit plans are inherently and appropriately passive with respect to the participants, representing someone else's property and not the participants', the same cannot be said of defined contribution plans. As to such plans, one can sensibly look through the account to the underlying investments and ask what role the participant should play in selecting them. But here we must face the second problem with Professor Alexander's proposal, the conflict between retirement security and employee "voice."

Under the present system, the employer has a choice. It can hand the management of investments over to specialists, or it can give the participants control over their accounts. The specialist will have only one goal: maximizing return at a reasonable level of risk. Modern portfolio theory leads such specialists to diversify the portfolio. ERISA also requires diversification.[18] With decisionmaking in the hands of an investment manager, a defined contribution plan is as passive as a defined benefit plan, from the participant's perspective.

Recognizing that employees often desire to manage their accounts, many firms adopt an intermediate approach. Employees are given a selection of various investments—money market funds, bonds, and equities. If participants exercise "control" over the assets in their accounts, ERISA provides that they are not deemed to be fiduciaries by reason of such control, and that no fiduciary shall be liable for any loss that results from such control.[19] Detailed Department of Labor regulations specify when a participant is deemed to have control over his or her account.[20] In particular, the participant must be offered a broad range of investment alternatives, including at least one relatively "safe" investment such as insured interest-bearing deposits in a bank or similar financial institution.

Even when employees are given a range of alternatives, encompassing various risks and rates of return, employees have tended to be risk-averse. Investment is routinely skewed to insured deposits or money market investments and away from equity. This lack of diversification into riskier investments inevitably produces a lower rate of return in the long run.

Although the administrative costs are greater, some firms permit even broader employee control. For example, employees could be given the power to invest in individual stocks, including stock of the employer. Such plans highlight the tension between active ownership and retirement security. The power to control property is the power to lose it. The retirement policy issue is

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18. "[A] fiduciary shall discharge his duties with respect to a plan . . . by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so." ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C) (1988).

19. 29 U.S.C. § 1104(c).

20. 57 Fed. Reg. 46,906 (1992) (to be codified at 29 C.F.R. pt. 2550).

whether we should permit an employee to manage incompetently his or her retirement savings, or even to gamble intentionally with it in the hope of achieving above-market rates of return.

Professor Alexander concedes that there is a trade-off between employee "voice" and risk, but on balance attaches a greater weight to "voice." I reach the opposite conclusion. There is no doubt that greater control over one's life is a worthy goal, but society often narrows the range of individual choice. It is part of the compromise we are forced to make when we participate in human society. There are, of course, many who object to all paternalistic policies of government. They argue that each individual has a right to drive a motorcycle without a helmet and each individual has the right to invest his or her retirement savings in the Silicon Valley start-up company of his or her choice. For some it is a matter of natural law, the inalienable right to be wrong as a moral end in and of itself. For others, and I think Professor Alexander is among them, it is a matter of the social gains to be achieved by increased individual responsibility, namely, concern for the consequences of one's use of property and the development of civic virtue. As to the former group, there can be no answer. For them, paternalism is immoral. As to the latter group, the debate concerns whether the social gains associated with increased "voice" are outweighed by the social risks of retirement insecurity. I find such gains rather abstract and philosophical, and somewhat speculative, whereas the risks are all too real.

Our elected representatives have consciously chosen a paternalistic retirement system. The basis of this decision is the belief that many individuals often will not act in their own best interests in deciding how and when to save for retirement, a belief supported by psychological evidence.[21] We force each other to save for retirement through the mandatory Social Security system, and encourage additional saving through employer pensions, which, although not mandatory, are heavily subsidized by generous tax incentives. The tax expenditure attributable to these incentives is estimated to be $56.5 billion per year.[22] Allowing participants to put their retirement savings at risk is inconsistent with the purpose of this subsidy.

Even if one were convinced to give greater weight to the need for employee "voice," Professor Alexander's linking of such "voice" to workplace democracy seems misplaced. Given greater freedom to control their retirement funds, would employees necessarily invest in their employer? In Employee Stock Option Plans ("ESOPs"), employees are compelled to invest their retirement funds primarily in the stock of their employer. They have a right to diversify only when they reach age fifty-five and complete ten years of participation.[23]

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21. *See* Deborah M. Weiss, *Paternalistic Pension Policy: Psychological Evidence and Economic Theory*, 58 U. CHI. L. REV. 1275, 1318 (1991).

22. Estimates of Federal Tax Expenditures for Fiscal Years 1993-1997, Joint Committee on Taxation Staff Description (JCS-8-92) 17, tbl. 1.

23. I.R.C. § 401(a)(28) (1992).

If responsibility is the goal and passivity the enemy, why not allow workers to diversify at any age?

Compelling employees to invest all or a portion of their retirement savings in their employers reduces their responsibility, since certainly a key feature of classical ownership is the right to change one's investment, that is, to exchange one type of property for another. Although Professor Alexander recognizes that the modern ESOP is really more of a corporate finance device and is critical of ESOPs for their lack of true employee democracy,[24] he seems to accept a system that would compel employees to invest in their employers.

In my view, ESOPs have no place in the tax-favored retirement system. They provide precious little security to employees. Imagine how much worse the steelworkers would be if their retirement savings were in a steel company ESOP.[25] Only after there is some minimum level of retirement security can one link retirement investing to such assets. Even then, one has to wonder why ESOPs should receive such favorable tax treatment.

There are many people and interest groups who see the $2.2 trillion in corporate pension funds and the $800 billion in public funds as a solution to a wide variety of problems. They have ambitious plans for targeted investing, whether in the workplace, the community, the decaying cities, or elsewhere.[26] There is great danger in compromising the current goal of maximum retirement security. The result could be hopeless politicization and conflict, not to mention reduced retirement saving. As Professor Stein has pointed out in his symposium article,[27] social investing, *if it actually makes a difference*, is never costless.

24. The democratic defects noted by Professor Alexander could be cured in large part by allowing the pass-through voting of the unallocated shares. In my view, the statute permits this, but the Department of Labor obviously disagrees. *See* Opinion Letter on Tender Offers, 16 Pens. Rep. (BNA) No. 9, at 351, 390 (Feb. 23, 1989).

25. Although not an ESOP, Carter Hawley Hale Stores 401(k) plan invested solely in employer stock, which led to a severe erosion of the employees' retirement savings when Carter Hawley entered Chapter 11 bankruptcy proceedings. *See* Francine Schwadel, *Carter Hawley 401(k)'s Yields Fall Short*, WALL ST. J., June 18, 1992, at C1.

26. For a discussion and critique of some of these plans, see Stephen E. Clark, *Tapping Pension Power to Rebuild America Inc.*, INSTITUTIONAL INVESTOR, Mar. 1992, at 45.

27. Norman Stein, *ERISA and the Limits of Equity*, 56 L. & CONTEMP. PROBS. 71 (Winter 1993).