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## FORUM COMMENTARY

### THE “PRUDENT RETIREE RULE”: WHAT TO DO WHEN RETIREMENT SECURITY IS IMPOSSIBLE?

by  
*Jeffrey N. Gordon*\*

The starting question for public policy analysis in the retirement security area ought to be this: “Is retirement security possible?” My text is drawn from the classic trust case *Harvard College v. Amory*, decided in 1830, in which the Massachusetts Supreme Judicial Court announced the prudent investor rule by stating, “Do what you will, the capital is at hazard.”<sup>1</sup> The modern understanding of that text is not that there are no “risk free” assets. After all, the United States government assures the timely payment of principal and interest on Treasury securities backstopped in turn by Treasury’s unlimited call on the money-creation capacities of the Federal Reserve. Rather, we understand that even if principal and interest are paid as promised, that still leaves inflation-related risk to the purchasing power of trust assets.<sup>2</sup> In that sense, “the capital is at hazard.”<sup>3</sup>

In a similar spirit, the answer to our question about the possibility of retirement security is, “of course not.” The measures that might reduce the risk that promised benefits will not be paid would increase sharply the risk that pension payments will fall far short of adequate retirement income. Thus, much as the *Harvard College* court endorsed the prudent trust investor, we are left then to derive what might be called “the prudent retiree rule.” This short Paper has two objectives: first, to outline some of the risks that operate in the retirement security realm; and second, to try to fashion a sense of which risks it

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\* Alfred W. Bressler Professor and Albert E. Cinelli Enterprise Professor, Columbia Law School. This is adapted from a luncheon talk at the Lewis and Clark symposium on “The Aging of the Baby Boomers and America’s Changing Retirement System,” September 29, 2006. The talk was much informed by the papers presented at the symposium, only partially reflected by the citations below, and by discussion with conference participants. My particular thanks to Henry H. Drummonds, the organizer. Thanks as well for comments from John Langbein and Lance Liebman. I do not purport to address the vast literature on pensions and retirement security.

<sup>1</sup> 26 Mass. (9 Pick.) 446, 461 (1830).

<sup>2</sup> See Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U. L. REV. 52, 100 (1987).

<sup>3</sup> *Harvard Coll.*, 26 Mass. (9 Pick.) at 461.

is prudent to bear, both as a society in which everyone who is lucky will retire, and then as individuals. The risk factors to consider are demographic risk, economic risk, and distributional risk. These operate in different ways given the source of the retirement income at present: the general society, the firm, and the individual.

Critical to understanding how these risks operate in the design of a prudent retirement system is that the effort to defease the system of such risks will produce another risk, shortfall risk—meaning the risk that retirement payouts will fall significantly short of the social satisfaction level. Thus one claim I will try to defend is that the prudent retiree rule permits a reasonable level—a prudent level—of what might be called “contingent funding” of retirement payouts. The level and form of prudent contingent funding will vary depending on the source of the pension payout.

To put things more simply, we might think of two distinct risks in retirement payout planning: “payment risk” and “shortfall risk.” “Payment risk” is the risk that a particular pension promise (or expectation) will not be paid in accordance with its terms because of insufficient funding. “Shortfall risk” is the risk that the promised (or expected) pension payouts will be inadequate for a satisfactory retirement. “Contingent funding”—basing a pension expectation on funding sources that may not materialize—increases payment risk. Yet pension systems without some contingent funding will provide inferior benefits in most states of the world, increasing shortfall risk. The trade-off is inescapable. This is because mitigation of payment risk is costly, and those costs are ordinarily borne by payment recipients in the form of lower promised (or expected) benefits. Thus the prudent retiree rule permits a prudent level of contingent funding. The contingent funding component can be at the firm level, as in the case of defined benefit plans, or at the individual level, as in the case of defined contribution plans, or at the societal level, in the case of social security. It can take different forms: underfunding (in an actuarial sense) of defined benefit promises, which means reliance on the firm’s continued profitability; a tilt toward equity, including an appropriate level of employer own stock in a defined contribution plan; and reliance on pay-as-you-go (PAYGO) funding of social security benefits in which each generation funds its predecessor’s benefits.

*Anti-defeasement.* Since the anti-defeasement point is foundational, let me illustrate it with two examples, one from pension finance and the other from retiree health care benefits.

In the wake of Pension Benefit Guarantee Corporation (PBGC) bailouts in the airline industry and its current negative \$23 billion net balance sheet position, some economists have proposed significant risk reduction in pension plan funding.<sup>4</sup> Either firms should hold immunized portfolios of pension assets

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<sup>4</sup> See David W. Wilcox, *Reforming the Defined-Benefit Pension System*, 2006 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 235, 235–304 (including discussion). Wilcox, for example, believes that one of the “axioms” for design of a defined benefit system is that employees “should be able to view the promise of a DB pension as free of risk.” *Id.* at 238–39 (citing work to similar effect by noted economist Zvi Bodie). He looks for reforms to

(meaning risk-free assets whose payment streams are matched to pension liabilities), or firms that hold risky assets should pay an insurance premium calibrated to the risk presented by the investment strategy and credit-worthiness of the sponsoring firm. Moreover, firms that add to expected pension payouts (for example, through wage increases) should quickly amortize the unfunded liability. These measures will avoid either a subsidy from the taxpayers or from other, lower risk plan sponsors and will discourage moral hazard by firms either in over-promising benefits or in undertaking risky strategies to fund promised benefits on the cheap. More generally, more secure pension funding means lower payment risk.

Yet it is worth bearing in mind why firms moved from portfolio immunization strategies in the 1980s: the expected return on an appropriately diversified market index of risky securities is considerably higher than the expected return on the risk-free asset. This made firms more willing to maintain defined benefit plans and existing benefit levels. Put otherwise, with a risk-free funding strategy, firms would either have to significantly increase contributions to the pension plan or significantly scale back the promised benefits. In other words, it is possible to reduce payment risk only by increasing shortfall risk.

Yes, there are genuine moral hazard problems that a government pension guarantee gives rise to, including excessive risk-taking by firms in the vicinity of insolvency, because of the connection between pension fund investment performance and firm cash flows (increases in the value of pension assets reduce present funding obligations). But the typical firm that takes advantage of the Employee Retirement Income Security Act's (ERISA) prudent investor rule to engage in higher expected value strategies is posting its substantial going concern value as a bond against poor investment performance.<sup>5</sup> A decrease in asset values will increase the firm's current funding obligations. Before the PBGC is called on to perform on a defaulted pension promise, the shareholders will have been mostly wiped out and incumbent managers have lost their jobs. From a different perspective, do we want to give management another reason to resist wage or benefit increases: that immediate funding requirements for the new pension liabilities will sop up cash flow that might be invested in the firm's business?

A second example that illustrates the anti-defeasement point is retiree health care benefits. A defined benefit promise is to make a particular dollar payout; this payout may change over time (e.g., if wages increase), but most changes are within management's control. Thus, estimating pension liabilities is subject to standard risk analysis: in light of forecastable parameters (e.g., lifespan, wage increases, historical rates of return), produce a distribution of outcomes with mean and variance. By contrast, the retiree health care promise is for a service whose cost changes over time in ways that are very hard to

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achieve that result while at the same time reducing potential subsidization by the government (through provision of underpriced guarantees) or by other firms (whose premiums will rise to bolster PBGC reserves).

<sup>5</sup> Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, tit. I, § 404(a)(1), 88 Stat. 829, 887 (codified as amended at 29 U.S.C. § 1104 (2000)).

predict, that may suddenly escalate, and which, ideally, will even increase one of the key cost drivers: lifespan. Instead of risk, we have uncertainty—known unknowns, as a former government official said in different context.<sup>6</sup> Try to defease that risk! The only way to do it is to convert the promise from the cost of service to a fixed payout (that is, payment of medical costs to a predetermined cap) which may have advantages for the shareholders but not for the employees.

In both of these cases, then, the avoidance of shortfall risk requires some element of contingent funding. If over a particular time period, the portfolio of risky assets returns significantly less than the expected return (for example, 1999–2003 for many firms), the firm will have to increase its current contribution to fund previously accrued pension liabilities up to the funding standard. If retiree health care costs escalate, the firm will have to pony up current earnings to pay for previously accrued retiree health care obligations.

Contingent funding necessarily entails risks for their beneficiaries, their obligors, and the guarantors. Mounting pension costs come of out shareholder profits. If the firm becomes insolvent with unfunded pension liabilities, the costs under present arrangements are shared between the plan beneficiaries (retirees as well as current employees) and the PBGC.<sup>7</sup> As health care costs escalate, either the firm pays, or the firm redefines the service that it is prepared to provide, shifting costs to beneficiaries, although in this particular case the beneficiaries may still be better off (if the value of health care improvements exceed the shifted costs).

*Risks in retirement security.* Now to turn to the different risks in retirement security planning, previously identified as demographic risk, economic risk, and distributional risk, each operating on the social, firm, and individual dimensions. The basic question relevant to each risk factor is, “How does it affect the funding of undefeased retirement risk?”

The first two factors, demographic risk and economic risk, affect the amount of the resources available. The third, distributional risk, has a distinct role in the allocation of resources.

*Demographic risk.* Demographic risk refers to the ratio of current workers to retirees, the “coverage ratio.” For retirement benefits funded by the government, this ratio has obvious importance. In a country with a very high ratio of current employees to retirees, funding social security (or socialized retiree health care) on a PAYGO basis presents few financial problems. Some of the arguments on behalf of the Bush administration’s social security reform proposals sounded in the shifting coverage ratio between the 1930s and the

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<sup>6</sup> See Hart Seely, *The Poetry of D.H. Rumsfeld*, SLATE, April 2, 2003, <http://www.slate.com/id/2081042/>.

<sup>7</sup> Strictly speaking, employee pension risk-sharing with PBGC operates only in the case of the highest levels of employee compensation—the pilots, for example, in the recent wave of airline bankruptcies, not the machinists or flight attendants whose vested defined benefit payments are fully guaranteed. On the other hand, as plans are closed down, those vested benefits are frozen (for current employees) at levels below what they expected upon retirement.

2000s, even though the current demographic changes were foreseen and included in the Greenspan-led reforms of Social Security in the early 1980s.<sup>8</sup> Europe and particularly Japan face a far more serious demographic challenge in their ability to sustain public pension coverage than the United States. Birthrates and other forms of working-age population growth are higher in the United States, in part because of our traditional hospitality to immigrants.

At the firm level, the coverage ratio has important,<sup>9</sup> but (as we shall see) not dispositive, implications. Obviously if the firm has many current employees but few retirees (for example, a start-up or a rapidly growing firm), the funding obligation for retirement income or retiree health care will be easy to bear. In particular, holding size of the active workforce constant, a mature firm will have a much heavier health care burden than a young firm. On this dimension, Toyota’s younger work force at its U.S. plants will impose much smaller retiree health care costs than at GM or Ford, and similarly Southwest Airlines and TransAm will for now be untouched by retiree costs that have affected the finances of pre-deregulation trunk carriers like American Airlines or Delta.

At the individual level, the demographic risk matters too. A highly cost-effective form of home health care is provided by the family, typically one’s offspring.<sup>10</sup> The more children the more likely that they can pool resources—pecuniary as well as in-kind—to care for Mom or Dad, or, on another front, to supplement Mom and Dad’s retirement income, if inadequate. Put otherwise, shrinking family size puts additional pressure on existing public resources and gives rise to political pressure to create new ones.

*Economic risk.* The most significant source of risk to retirement security, particularly with PAYGO schemes, is economic. At the level of society, the resources available to fund various retirement benefits are principally a function of economic productivity and growth and other economic factors. Medicare was adopted in the midst of the 1960s boom, a time of budget surplus, and was radically underfunded from current premiums from the start. This was in part because of the “transition problem” associated with coverage of retirees or near retirees whose accumulated pay-in was small relative to benefits received. Medicare Part D, the new prescription drug benefit for seniors, was also underfunded. It was adopted despite large current budget deficits because of, among other things, tax revenue growth projections from true-believers in the elixir of tax cuts and because of capital inflows to the U.S., particularly from emerging economies, that reduced the Treasury’s cost of deficit finance.

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<sup>8</sup> See Kathryn L. Moore, *Social Security Reform: Fundamental Restructuring or Incremental Change?*, 11 LEWIS & CLARK L. REV. 341, 359 n.108 (2007).

<sup>9</sup> The point has been made much of recently. See, e.g., Malcolm Gladwell, *The Risk Pool: What’s Behind Ireland’s Economic Miracle—and GM’s Financial Crisis?*, NEW YORKER, Aug. 28, 2006, available at [www.newyorker.com/fact/content/articles/060828fa\\_fact](http://www.newyorker.com/fact/content/articles/060828fa_fact).

<sup>10</sup> Richard L. Kaplan, *Retirement Planning’s Greatest Gap: Funding Long-Term Care*, 11 LEWIS & CLARK L. REV. 407, 411 (2007).

The solvency or not of Social Security in 2040 is principally a function of growth rates, and a shift of less than one percent in expected average annual GDP growth, compounded over decades, is the difference between surplus and fiscal distress.

The firm level is where we currently see the bite of the economic risk factor. Firms that lose their economic competitive advantage lose their capacity to distribute rents to their stakeholders, whether stockholders or employees with robust benefit packages. Global competition arguably makes that an increasing challenge.<sup>11</sup> But a decline in the coverage ratio of current workers to retirees—the firm level demographic risk—would not matter if productivity gains and profitability rose even faster. Some may claim an interaction between growth and firm demographics, in that legacy obligations covered out of current cash flows reduce competitiveness, which reduces growth, and thereby increases the relative burden of legacy costs, a death spiral. This need not be the story where the product is not a commodity—where the firm can hold onto its competitive advantage and continue to earn economic rents. GM's troubles stem in significant part because of its difficulty in designing and manufacturing cars that a significant segment of the relevant market finds attractive.

Consider this perspective on economic risk. The pre-deregulation airlines had some of the most lucrative pension benefits going, which flowed from the regulatory insulation from competitive pressure.<sup>12</sup> In the assorted post-deregulation airline bankruptcies, the PBGC has borne large liabilities. But from a social point of view, aren't we better off in the post-deregulatory world, even taking into account the PBGC's costs and the necessary taxpayer subvention? That is, what created the problem for the airlines is that all their rents were competed away in the deregulated environment. The gain in consumer surplus is huge. Some of these rents had been shared with employees in wages and benefits, and employees too lost those rents. The resort to PBGC guarantees to (partially) cover previously accrued claims can be seen as a form of transition relief, a sharing of the adjustment costs (and benefits) of economic change.<sup>13</sup>

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<sup>11</sup> See Katherine V. W. Stone, *A Fatal Mismatch: Employer-centric Benefits in a Boundaryless World*, 11 LEWIS & CLARK L. REV. 451, 453 (2007). See also David Charny, *The Employee Welfare State in Transition*, 74 TEX. L. REV. 1601 (1996).

<sup>12</sup> See *Current Situation and Future Outlook of U.S. Commercial Airline Industry: Hearing Before the Subcomm. on Aviation of the H. Comm. on Transportation & Infrastructure*, 109th Cong. 19 (2005) (statement of Mark Kiefer, Associate Principal, CRA Int'l, Inc.); U.S. Gov't Accountability Office, *Commercial Aviation: Bankruptcy and Pension Problems Are Symptoms of Underlying Structural Issues* (Sept. 2005), available at <http://www.gao.gov/new.items/d05945.pdf>.

<sup>13</sup> See also Henry H. Drummonds, *The Aging of the Boomers and America's Changing Retirement System*, 11 LEWIS & CLARK L. REV. 267, 277-278 (2007) (discussing PBGC intervention to minimize losses in airline pilots' pension plan). See generally Jeffrey N. Gordon, *Employee Stock Ownership As a Transitional Device: The Case of the Airline Industry*, in HANDBOOK OF AIRLINE ECONOMICS 575 (Darryl Jenkins & Cecilia Preble Ray eds., 1995) (discussing employee stock ownership in the context of deregulation and increased competition in the airline industry in the late 1970s and early 1980s).

More generally, in a world of limited competition—either because of government regulation like the airlines or because of apparent competitive advantage like the United States’ post-World War II steel industry—a firm may share some of the rents with employees. This can occur not only through higher wage levels, but also by giving employees a share in growth and expected future growth through the common features of a defined benefit pension plan.<sup>14</sup> This may create a funding gap that will not be immediately amortized. Then the world changes, the rents disappear, the contingent funding scheme fails, and the payment promise cannot be met. Even if the guarantee is called to bail out the plan (really, to bail out the employees), aren’t we, the society, better off with low prices and high consumer surplus than high prices and lots of producer rents? The PBGC’s guarantee can be seen as a useful kind of social insurance. Like all insurance schemes, it may give rise to particular forms of moral hazard, but in light of the shareholder equity “deductible” embedded in the guaranty scheme, there is no reason to believe that the pension commitments themselves have arisen because of the guarantee.

Turn now to economic risk faced by individuals. The individual’s capacity to save for retirement income and retirement health care costs is powerfully affected by economic factors. The limit of individuals’ capacity to make wise investment choices is a theme of many of the papers at this conference, which propose various ameliorative steps.<sup>15</sup> But even with good investment decisionmaking, results may be poor because of macroeconomic effects. For example, if you retired in 2002 and wanted to annuitize a portfolio that had included a significant equity allocation (so invested to reduce longevity risk), your retirement income expectations would have taken a severe beating as against, say, retirement in 2000. If your firm is in an economic sector subject to a deregulation shock or a shift in consumer taste or a profound innovation, you may find yourself unemployed. More generally, assumptions about long-term, stable employment may have shifted, radically destabilizing individual earnings expectations.<sup>16</sup>

*Distributional risk.* Distributional risk, which pertains to individuals, is of two types. The first type relates to individual characteristics such as race, ethnicity, family background, and especially the level of bequeathed educational and social capital.<sup>17</sup> The second type relates to the interaction of personal characteristics and the wage structure in the economy at a particular point in time. Over the last two decades we have seen the shrinkage of the

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<sup>14</sup> These are described below, following Jeffrey N. Gordon, *Employees, Pensions, and the New Economic Order*, 97 COLUM. L. REV. 1519, 1541, 1544–46 (1997).

<sup>15</sup> E.g., Samuel Estreicher & Laurence Gold, *The Shift From Defined Benefit Plans To Defined Contribution Plans*, 11 LEWIS & CLARK L. REV. 331 (2007); Susan J. Stabile, *Is It Time to Admit the Failure of an Employer-Based Pension System?*, 11 LEWIS & CLARK L. REV. 305 (2007).

<sup>16</sup> Stone, *supra* note 11, at 13–14.

<sup>17</sup> See Dorothy A. Brown, *Pensions and Risk Aversion: The Influence of Race, Ethnicity, and Class on Investor Behavior*, 11 LEWIS & CLARK L. REV. 385 (2007).

middle class.<sup>18</sup> This is not the place to review the evidence of increasing disparities of income distribution in the population, but it appears that a significant part of this phenomenon is the result of exogenous change, for example, political decisions taken by Chinese leaders to pursue an export-driven development strategy that affects global product, capital, and labor markets, or the technology embedded in high-speed broadband connections that transforms global supply networks.<sup>19</sup> These kinds of changes create risk at the individual level that is very difficult for individuals to hedge against. It affects lifetime income as well as retirement security provided by the private sector. Employees at the high end have robust retirement security from special firm-level arrangements as well as private assets. Employees at the bottom—the bottom 50 percent—have almost no private sector-provided retirement plan.

*What follows.* So what do we do with these risks in the case of retirement planning? What is the Prudent Retiree Rule?

The easy solution, but wrong, is that because the government is the optimal bearer of economic risk, most retirement security should be socialized. Government in this role certainly has many advantages: it can diversify revenue-raising across all sectors of the economy and pool economic risk across all segments of the population; it has a unique capacity to engage in intergenerational risk-sharing. And for all of these reasons it makes for an unmatched provider of the social safety net, Social Security. In this regard, Social Security's funding problems are much-overstated, or rather, the current degree of funding risk is well within the prudent retiree rule. In the most basic sense, there is no "funding" problem. Social Security taxes are just that, taxes; Social Security payouts are just government payments, and all the rest is politics.<sup>20</sup> The present Social Security finance system is a political economy device to restrain the redistributive levels of Social Security payouts: to force in

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<sup>18</sup> See Annenberg Political Fact Check, Update on Kerry's "Shrinking Middle Class"—Still Shrinking in 2003 (Sept. 1, 2004), <http://www.factcheck.org/article249.html> (citing CARMEN DEHAVAS-WALT ET AL., U.S. CENSUS BUREAU, INCOME, POVERTY, AND HEALTH INSURANCE COVERAGE IN THE UNITED STATES: 2003 (2004), available at <http://www.census.gov/prod/2004pubs/p60-226.pdf>).

<sup>19</sup> See Vincent C. Avagliano, *The Second Wave: IT Outsourcing, Globalization, and Worker Rights*, 23 PENN ST. INT'L L. REV. 663, 664 (2005) ("As capital voracity for developing foreign markets is concomitantly matched by technological advances which facilitate supplying the demand for information technology (IT) and foreign direct investment, many services . . . are continually relocated outside of the country."); Paul Craig Roberts, Trade Dogma and the No-Think Nation (April 23, 2002), [http://www.vdare.com/roberts/no\\_think.htm](http://www.vdare.com/roberts/no_think.htm) ("We are confronted with massive desertion of industrial and high tech production and R&D to China and a consequent decline in middle class jobs and incomes in the U.S."); Lou Dobbs, *The State of Our Union*, CNN.COM, Feb. 2, 2006, <http://www.cnn.com/2006/US/02/01/our.union/index.html> ("Since 1989, the U.S. economy has dumped more than 1.5 million jobs because of dislocations caused by the U.S.-China trade deficit.").

<sup>20</sup> This is not in any sense to demean "politics." Most important social decisions are resolved in that way and appropriately so. But the arguments, which also matter, do change. See Moore, *supra* note 8, at 356 (citing Franklin D. Roosevelt, who at the time saw the creation of a fund linked to payroll taxes as protection against repeal of the program, and modern commentators who are concerned with curbing benefits).

a significant way the indexing of payouts to earnings and thereby cap payout levels. To do otherwise is to invite excessive moral hazard by individuals and firms when it comes to savings and investment decisions.<sup>21</sup>

Unlike some, I see no necessary criticism of private firms because only 50% of employees have private pension coverage. In many cases that is simply the result of low prevailing wages, a state of affairs in which the employee understandably may prefer current income to deferred income.<sup>22</sup> Here is where Social Security plays a crucial role: it's the retirement equivalent of the Earned Income Tax Credit, a transfer program where the government provides a supplement when the prevailing wage is below the socially accepted living wage. For those who benefit from Social Security's redistributive formula, the program provides a deferred cash supplement where the job does not provide sufficient socially accepted retirement security. From this perspective, the relevant questions are: what is that acceptable level, and whether to strengthen Social Security's connection to work (in a manner similar to the EITC).

This brings me to my main theme: retirement security planning and funding is part of an overall economic system of incentives to work, save, and invest, which produces (among other things) a stream of present and future wages. Retirement payments to a significant degree need to be tied to social productivity and individual productivity. This means a certain level of economic and distributional risk is inescapable. The only way to drive risk out of that system is to reduce significantly the potential for upside payments. A prudent retiree rule accepts this risk and tries to cope with it.

In such cases as the airline and the steel industries and the world of the typical successful firm that enjoys some competitive advantage at the time of entering into a pension promise, I think a prudent retiree rule would be somewhat forgiving of an incompletely funded pension promise (and some degree of contingent funding) precisely because moral hazard risk at the firm level is relatively small. As I have previously argued, the defined benefit promise is a good way to give employees a share of economic gains through

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<sup>21</sup> On the other hand, as Lance Liebman has observed, different risks in the funding of pension payouts and retiree health care may argue that the government rather than the firm should cover retiree health care costs. *See, e.g.,* Lance Liebman, Comment, *U.S. Social Welfare Policy*, 2 COLUM. J. EUR. L. 457 (1996). The increasing costs of retiree health care require a significant element of PAYGO funding which the government is better able to manage than firms. PAYGO for retiree health care also entails intergenerational questions that are the appropriate domain of government, both in the determining the appropriate care level as well as funding. By contrast, health care benefits for current employees are more readily internalized by customary insurance mechanisms available to firms. Finally, unlike pension payments by the firm, which we permit to vary like salaries, retiree health care faces a strong equality norm. This too pushes in favor of government funding. Of course this equality concern may have other implications: why should the government take on additional health care protection for a relatively privileged group, those who have had employer-sourced health insurance during their working years, when many others are uninsured altogether?

<sup>22</sup> Low wages also interact with the tax treatment of retirement savings, which, given progressive tax rates, means that low income individuals receive less tax incentive to engage in retirement savings than higher income individuals.

wage increases that would be impounded into pensions—as the wage curve shifts up, so does the value of the pension claim.<sup>23</sup> For the successful firm with increasing going concern value, the shareholder equity secures the unfunded portion of a defined benefit plan. Such under-funding can arise when the firm adds benefits or reduces expected pension-plan-return assumptions in light of changing market conditions. For the successful firm, shareholder value coinsures the PBGC over the amortization period of the unfunded liability.<sup>24</sup> As manifested by shareholder reaction to new disclosure requirements for pension and retiree health care liability, shareholders are much more vigorous than the PBGC in policing benefit levels.<sup>25</sup>

Nevertheless the day of the defined benefit plan may be past,<sup>26</sup> with at best 20 more years. Thus, the pressing policy question is whether the substitutes, 401(k) plans and other defined contribution plans, increase or decrease employee risk and how to make a better fit to the prudent retiree rule.

On two risk dimensions, defined contribution plans should, in theory, reduce employee risk even without a PBGC guarantee. First, defined contribution plans can eliminate the risk of employer plan insolvency and non-payment. Second, they can also eliminate the risks that arise because of job mobility and the associated losses of the expected value of the defined benefit payout in light of the typical formulas that favor long-tenured employees.

“In theory” may be the relevant term for these sorts of risk reduction, however. A defined contribution plan that is heavily invested in employer stock may have a worse payoff in the case of employer insolvency than a defined benefit plan with a PBGC guarantee. First, ERISA’s prudent investor rule significantly limits investment in employer stock by a defined benefit plan; this protects the value of plan assets despite employer insolvency. Moreover, the PBGC guarantee covers at least a portion of unfunded pension undertakings and provides a substantial floor. By contrast, at the time of the Enron et al.

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<sup>23</sup> See Gordon, *supra* note 16, at 1544.

<sup>24</sup> In the era of leveraged acquisitions and recapitalizations, appropriate subordination rules will be necessary to control that dimension of potential shareholder opportunism. That is, a transaction in which shareholders withdraw significant equity (or real assets) at a time of pension plan under-funding is a kind of fraudulent conveyance in which the PBGC as guarantor and the plan as a entity should be able to obtain relief from the shareholders (and those who act in concert) either directly or indirectly through subordination provisions on the new debt. See also Drummonds, *supra* note 13, at 279 (providing examples of opportunistic management behavior).

<sup>25</sup> Michael C. Jensen, Kevin J. Murphy & Eric G. Wruck, *Remuneration: Where We’ve Been, How We Got to Here, What Are the Problems, and How to Fix Them* (Harvard Bus. Sch., NOM Research Paper No. 04-28, 2004), available at <http://ssrn.com/abstract=561305> (describing widespread cutbacks in employer-provided retiree health care benefits following FASB adoption of FAS 106 in 1990, which required disclosure of liabilities).

<sup>26</sup> Stabile, *supra* note 15. One important substitute is the cash balance plan, which although a hybrid form of defined benefit plan, caps payouts in a way that makes it more like a defined contribution plan invested in fixed income securities. In a cash balance plan, the contribution comes from the employer (not the employee) but the “fund” earns a deemed rate of return typically tied to a fixed income instrument, which of course limits risk, upside and downside. Unlike the traditional defined benefit plan, the payout is tied to the contribution level and the rate of return, not to the years of the employee’s highest wage.

meltdowns, there was no limit on the fraction of employer stock in defined contribution plans and employees could be locked into long-term holding of employer-contributed own stock. In many cases retirement savings were wiped out. Even post-Enron reform legislation, the Pension Protection Act of 2006, provides merely that employers of public companies must provide diversification options in their 401(k) plans.<sup>27</sup> It does not cap the fraction of investment in employer stock or require employees to pursue the risk-lowering features of diversification.

“In theory,” too, defined contribution plans reduce switching losses in a churning workplace environment. Often, however, employees will exercise options to take lump sum payouts rather than transfer assets to a new plan. Such leakage degrades the buildup of employee pension plan assets.

Even if new rules or greater employee prudence could reduce these risks, “shortfall risk” remains, namely, the risk that the income stream eventually produced by the build-up of defined contribution assets will fall short of acceptable retirement income. Indeed, defined contribution plans at current funding levels create much greater shortfall risk than the defined benefit plans that are now fading from use.<sup>28</sup> The shortfall risk problem can be broken down into three concerns: first, the concern about employer funding levels; second, the concern about employee-driven investment management; and third, the concern about participation in the employer’s success, the upside.

To be more specific, the first concern is that employers will not contribute as much per employee in a defined contribution plan as in the case of a defined benefit plan. This would mean that defined contribution plans remain principally a cost-reduction vehicle for employers rather than more administrable, more equitable retirement savings vehicle in an era of high employee mobility.

There is another way to frame the employer contribution issue, of course, which is to appreciate that employees generally bear the cost of pension (and other fringe) benefits. Across a significant range, wages and benefits are substitutes. Defined benefit plans impose a paternalistic pension savings structure, which defined contribution plans do not. In industries and occupations where prevailing wages are sufficiently high, the comparable pension set-asides could be achieved with a series of behavioral devices, such as automatic “opt-in” features including ratcheting employee contribution levels and cleverly designed employer matches and other incentives (in addition to the government-provided tax deferral incentive) for additional employee contributions. In other words, from a policy perspective it is important to separate the shortfall risk that arises simply because low-wage employees rationally prefer present consumption from the risk that arises because well-paid employees irrationally fail to appreciate the need to save for retirement.

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<sup>27</sup> Pension Protection Act of 2006, Pub. L. No. 109-280, § 901, 120 Stat. 780, 1026–33.

<sup>28</sup> Cash balance plans also create shortfall risk. The key concern is that the employer contribution level (and a deemed rate of return) is likely to produce a lower payout level than a traditional defined benefit plan.

The second concern is the quality of employee investment management. Regardless of the contribution level, poor management will produce significant shortfall. Defined benefit plans provide professional management subject to ERISA's prudence constraints. There is ample reason for concern whether most individual employees are up to the challenge.<sup>29</sup> One possibly contrary example is the experience of defined contribution plans maintained by higher education, 403(b) plans. At many universities, the employer contribution is quite significant, reducing shortfall risk on that dimension, but the entire corpus is employee-managed. The institution provides a set of investment options and some investment counseling directly and indirectly through a third party investment manager. Nevertheless, employees make asset allocation choices. Although the range of asset allocation decisions suggests significant variance in retirement income among participants,<sup>30</sup> the lack of public outcry suggests that most outcomes have been within a tolerable range.

To take another example, private sector providers of pooled savings vehicles, especially mutual funds, are now providing funds geared to the date of anticipated retirement. This provides an easy way for the individual to delegate retirement-sensitive asset allocation decisions to professional managers. Various efforts to offer better investment advice to defined contribution plan participants will be facilitated by the safe harbors in the 2006 Pension Protection Act.<sup>31</sup> Obviously there is much room for creativity to promote more sensible management of employee retirement assets.

These reforms are aimed at improving the performance of the defined contribution vehicle. There is some element of contingent funding in plans where employees opt for some significant equity exposure. But what's missing in these reforms thus far is a strong-form contingent funding element, the upside element found in defined benefit plans. This is the third concern. The defined benefit formula embeds the upside in a payout formula tied to an employee's highest-income years in an environment of wages increasing with seniority in the successful firm. Employer stock in a defined contribution plan can provide something like that component. Annual stock contributions accumulate over time; annual allocations may increase with seniority; stock appreciation in the successful firm compounds the value of the accumulated amount. Care needs to be taken in setting the conditions for employer contributions of own stock. Although in the tax and accounting realms, employer contributions of own stock are valued at fair market value, it may nevertheless be the case that employers are rationally willing to contribute more of their own stock than the cash equivalent, and more own stock if it can be locked up in a contributory plan until retirement. This could be because

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<sup>29</sup> See, e.g., Julie R. Agnew, *Do Behavioral Biases Vary Across Individuals?: Evidence from Individual Level 401(k) Data*, 41 J. FIN. & QUANT. ANAL. 939 (2006) (an examination of several studies on the behavior of retirement investors).

<sup>30</sup> See Jacob. S. Rugh, *What Happened to TIAA-CREF Participant Premium and Asset Allocations from 2000 to 2004?*, RES. DIALOGUE (TIAA-CREF Inst., New York, N.Y.), June 2004, available at <http://www.tiaa-crefinstitute.org/research/dialogue/docs/80.pdf>.

<sup>31</sup> See Drummonds, *supra* note 13, at 298.

employers believe that employee stock ownership has useful incentive or coordinating effects,<sup>32</sup> or because the stock market assesses the dilutive impact of stock locked up in pension plans differently than freely tradable stock. This would mean that own stock contributions would be a relative bargain from the employer perspective. If the bargain is significant—and many employers must think so given the significant contributions of own stock in defined contribution plans—the value to employees could be notably greater than the cash that employers would otherwise contribute for employee investment on a more diversified basis.

The problem, of course, is that unlike the case of the defined benefit plan, there is no government guarantee of the defined contribution upside. Put aside the hopefully pathological case of Enron. A company could be prospering and its stock price appreciating until, kaboom, its business is overtaken by rivals or its technology becomes passé. The value of own stock held by near-retirement long term employees rapidly depreciates with little hope for recovery in the relevant time frame. There goes the upside and here comes the retirement payout shortfall.

It is hardly in the cards to create a government guarantee of the value of employer stock in defined contribution plans, nor should it be.<sup>33</sup> What would

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<sup>32</sup> Some have questioned the incentive effects of stock grants to non-senior management employees, on the argument that the effect of high effort or good decisionmaking by other employees has no visible connection to the stock price. Nevertheless, stock ownership has distinctive incentive and coordinating roles. Among other things, pervasive employee stock ownership provides a credible focal point—the stock price—for common assessment of the company’s performance. Accounting measures of profits may not adequately reflect comparative performance over time or against other firms, at least not without considerable interpretation; employees may suspect management “spin.” The stock price reflects the market’s judgment of performance relatively free of such potential distortion. Increasing the stock price becomes a goal to call forth a common, sustained effort even if individual contributions will be submerged. Stock ownership is a tangible form of employee “buy-in” to the success of the firm and thus may be important in building morale and esprit. In any event, it is plausible for management to believe these things and thus to value increasing employee ownership of own stock beyond immediate compensation objectives. *See generally* Jeffrey N. Gordon, *Employee Stock Ownership in Economic Transitions: The Case of United Airlines*, J. APPLIED CORP. FIN., Winter 1998, at 39, 59. The invention and judicial acceptance of the poison pill, a 1980s strategy of using employee stock ownership as an antitakeover device, seems unlikely to explain present practices.

<sup>33</sup> Though one might see Social Security as a kind of government guarantee for well-off employees who might invest aggressively in employer stock (or other speculative investments). No matter how badly the investment turns out, social security provides a “floor” level of retirement benefits. Social Security payroll taxes on this view are the insurance payment. The analogy doesn’t work perfectly because the guarantee is always paid, regardless of investment performance, subject of course through partial recovery via income taxes.

A more difficult question is why to provide direct government insurance for defined benefit plans and not for defined contribution plans. One answer is that in a competitive economy, it is predictable that some firms will fail. Insurance of firm level risk borne by individuals in a defined benefit plan who, among other things, have little power over the firm’s (or plan’s) decisions, seems appropriate mitigation of the adjustment costs of economic change. The formulas of defined benefit plans may also have particular economic value in encouraging

the prudent retiree rule counsel? I think the answer is a balance between investing to minimize payment risk and aggressive upside-seeking. That is, sophisticated investment management could provide a package of put options, asset substitutions, and derivatives that would hedge a portfolio of employer stock in an appropriate way given the investor's age and risk-bearing capacity. The problem, of course, is that the transaction costs for the individual employee portfolio would be prohibitive. But employers or, more plausibly, third party investment managers retained by employers, could economically provide such services on a pooled basis. In the same way that general investment vehicles can be targeted to specific retirement dates, it should be possible to create pooled risk-hedging vehicles for employer own stock for different age cohorts of employees. This is a fruitful direction to try to balance the imperatives of prudence with the needed gains from upside risk.

#### CONCLUSION

Is retirement security possible? In an important sense, the answer is no. What makes the problem hard is a see-saw effect: policies that minimize payment risk increase shortfall risk. The problem is also complicated by the interaction of social and individual risk factors. A robustly competitive economy is likely to increase social wealth overall and thereby to increase the capacity to fund social promises (or guarantees) of retirement payouts, but it is also likely to increase the risks borne by firms and individuals. Another complication is that a government guarantee entails not only funding concerns but may create moral-hazard effects at the firm or individual level. The prudent retiree rule reminds us that absolutes in this area are not possible, but also that we should take a sophisticated view of the factors relevant to fashioning a reasonable balance.

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longterm employee investment in firm specific human capital. By contrast, defined contribution plans with employee investment management can diversify away from firm specific risk. Non-insurance of the employer own stock upside "kicker" referred to in the text can be seen as analogous to the non-insurance of high end defined benefit payments.