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**THE GREAT PENSION GRAB:
COMMENTS ON RICHARD IPPOLITO,
*BANKRUPTCY AND WORKERS: RISKS,
COMPENSATION AND PENSION CONTRACTS***

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I want to thank Joel Seligman, Troy Paredes and Dan Keating for putting this conference together and for inviting me. I am not an expert on bankruptcy, so this is a great learning opportunity for me and it has been a terrific experience to be able to just absorb what is going on in this field.

I am pleased to comment on Richard Ippolito's Article,¹ which takes on several important ideas that I think deserve more attention from academic researchers. Ippolito models and attempts to assign a value to assets that employees have at risk in their employer firms.² Second, he documents and proposes to explain the significant changes that we have seen in the last two decades in the terms on which corporations provide pension benefits to their employees, when they provide them at all. Third, and perhaps most importantly, the Article documents some of the changes in the degree to which employees today are actually bearing substantial risk in connection with the business enterprises that they work for than they have historically.

I will start with a discussion of Ippolito's explanation of the changes in the pension plans and then make some comments on the significance of the fact that employees have become substantial risk bearers in corporations. Ippolito's paper documents that in 1998 only 16% of working people in the United States were covered by traditional defined-benefit pension plans. This was down from 38% in 1980. The overall percentage of working people who are covered by some form of pension plan has also declined. It was 54% in 1980 and it was down to 52% in 1998. Although small, that decline happened despite the fact that we had substantial aging of the population during that period, as well as an increase in the share of the workforce in full-time employment.³ So the

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1. Richard A. Ippolito, *Bankruptcy and Workers: Risks, Compensation and Pension Contracts*, 82 WASH. U. L.Q. 1251 (2004).

2. *Id.*; see also MARGARET MENDENHALL BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 263-67 (1995) (discussing attempts by labor economists to measure investments in firm-specific human capital).

3. See FRANK HOBBS & NICOLE STOOPS, U.S. CENSUS BUREAU, DEMOGRAPHIC TRENDS IN THE 20TH CENTURY 51-59 & 56 fig. 2.4 (2002), available at <http://www.census.gov/prod/2002pubs/>

fact that the proportion of people that are covered by any kind of pension benefits declined at all is surprising when you think about it in the context of demographic changes that have been underway.

More significantly the proportion of workers who are explicitly bearing the investment risk in their pension plans has increased dramatically from about 8% in 1980 to 32% in 1998.⁴ Ippolito documents that even within the category of defined contribution plans, the riskiness of the employee pension plans has increased because defined contribution plans are typically not optimally diversified: a large share of plan portfolios are invested in the stock or other securities of the employer.

One thing these changes suggest to me—which is not directly related to Ippolito’s Article, but I cannot resist the opportunity to point out—is that it would be really bad public policy to “reform” Social Security in ways that have the effect of moving people into defined-contribution types of arrangements. We already have a large share of workers who are bearing an enormous amount of risk in their pension plans and they do not appear to be optimally diversified as it is.

Ippolito’s explanation for this change in risk bearing for pension plans in the mid–1980s is that the federal government changed the rules for pension plans regulated under the Employee Retirement and Income Security Act (ERISA), and in the process made it possible for employers to unilaterally terminate their pension plans and suck the surplus assets in these plans back out of the plan and into the corporate coffers.

The polite word for this is “reversion.” It appears to me that the combination of the pension benefit guarantee insurance, which was put in place in 1974 for all contributions made to regulated defined-benefit retirement plans since 1974,⁵ plus granting firms the right to unilaterally terminate plans and allow reversions of surpluses, has had the effect of giving corporate employers both a put option and a call option that, together, dramatically reduce the risk born by the corporation or born through the corporation by shareholders and other investors. The reason is that when the returns on the pension portfolio are low, the corporation can “put” the pension assets to the Pension Benefit Guaranty Corporation

censr-4.pdf (showing the growth in the proportion of the population that is composed of older workers and retirees); see also BUREAU OF LABOR STATISTICS, U.S. DEP’T OF LABOR, WOMEN IN THE LABOR FORCE: A DATABOOK 52 tbl.18 (2004), available at <http://www.bls.gov/cps/wlf-databook.pdf> (showing the increasing share of women in full-time employment since 1970, offset somewhat, but not completely, by a decline of the share of working men who are in full-time employment).

4. Ippolito, *supra* note 1, at fig.12.

5. See 29 U.S.C. § 1461(a) (2000) (Sept. 2, 1974 was the first day that pension insurance took effect under ERISA.).

(“PBGC”), forcing it, rather than the employer, to satisfy the employer’s promised pension obligations. But if the return on a pension portfolio is unusually high, the corporation can terminate the plan and call back the surplus value in that plan. Thus the employer gets the benefit of the upside potential of what they invest in the pension portfolio. But they have offloaded the downside risk onto the PBGC and to the employees.

Consider the implications of this over time. In the 1980s, the discount rates used by corporations to determine what the present value of their pension obligations were, relative to the present value of the pension fund assets, were unusually high because of the high real interest rates of that period.⁶ As a result, corporations were more likely to find that the value of their portfolio investments had a tendency to be higher than the value of their obligation because high real interest rates imply a high discount rate, which has the effect of reducing the present value of the obligations.⁷ Then, in the 1990s, stock market prices rose dramatically.⁸ To the extent that corporate pension plans were invested in corporate securities, they likely participated in that run up of security values. Thus, throughout the 1990s we had another extended period in which there was more likely to be surplus value in pension plans than there would be under ordinary circumstances. The only way that the companies could get access to these surplus assets was to exercise their “call option” and terminate their plans.⁹

Apparently, many companies in fact did this, terminating the plans and capturing the surplus back for the corporation.¹⁰ Ippolito notes that many companies that terminated their pension plans, promptly replaced the plans with defined contribution plans and he suggests that defined benefit plans were not terminated because the companies were experiencing dire financial circumstances. Instead they were terminated simply to take advantage of the high “option value” in the plans.

6. Using the Fisher Equation, the real rate of interest is the nominal rate minus the inflation rate. Before 1981, and more recently, real rates have tended to fall within the 2%–3% range. During the 1980s, 7%–8% rates were typical. See U.S. GOV’T PRINTING OFFICE, BUDGET OF THE UNITED STATES GOVERNMENT: ECONOMIC REPORT OF THE PRESIDENT, 2004 (STATISTICAL TABLES) tbl.B-63 & tbl.B-73 (2004), available at <http://www.gpoaccess.gov/usbudget/fy05/erp.html#erp5> [hereinafter ECONOMIC REPORT OF THE PRESIDENT] (giving data on the CPI to gauge inflation and the prime rate to gauge the nominal interest rates).

7. See, e.g., RICHARD A. BREALY ET AL., FUNDAMENTALS OF CORPORATE FINANCE 62–65 (3d ed. 2001).

8. From 1990 to 2000 the S&P 500 index climbed from 334.59 to 1427.22 points. See ECONOMIC REPORT OF THE PRESIDENT, *supra* note 6, at tbl.B-95.

9. See 29 U.S.C. §§ 1082–1083 (2000) (stating minimum pension funding standards, as well as waiver of minimum funding standards and amortization of payments authorized by statute).

10. Ippolito, *supra* note 1, at 1278–83.

Ippolito models the value of the pension funds to the employees. He compares the value of funds that are insured to the value of funds that are uninsured and he observes that, once corporations have the right to terminate their plans even when they are not in financial distress, this has the effect of reducing the value of the defined benefit plans to employees because now there is a greater risk that the plan will be terminated even when it is “in the money,” and in fact, especially when it is “in the money.”

Ippolito’s model demonstrates that if employees are risk-averse, risky pension plans may be a very costly way to compensate them. He assumes, on the basis of his model that the change in employer policy had the effect of increasing the riskiness of defined-benefit plans for the employees and therefore reducing the value of those plans to employees because employees are risk averse. But he then concludes, without direct evidence, that the decline in value to employees must have exceeded the amount employers saved by the policy change. This, he says, explains why employers switched to defined contribution plans. However, giving employers reversion rights should also have reduced the *cost* of defined-benefit plans to employers substantially, because now they have a call option on the upside value in a defined-benefit plan whereas they have no similar “call option” value on the upside potential of defined-contribution plans. So Ippolito’s story does not necessarily explain why companies would switch to defined contribution plans. He might be right, but I need more evidence to be convinced that this is the explanation for the switch to defined contribution plans.

Unless there is a rule that says once you have terminated the defined benefit plan you can not turn around and start another one, then it seems to me that it would make sense for employers to terminate defined benefit plans whenever the call value is high and then start another defined benefit plan.¹¹

This analysis suggests a real puzzle: why would corporations, especially corporations that are trying to maximize value for shareholders, find it attractive to push risk off to their employees, if employers in fact must compensate employees for that additional risk? Surely shareholders are much more efficient risk bearers than employees. So an optimal contract, As Ippolito’s own model suggests, would remove risk from the

11. The Department of Labor, which regulates defined-benefit plans, has apparently imposed some limits on employees’ abilities to do this. *See* News Release, Pension Benefit Guaranty Corporation, ERISA Agencies Announce Implementation Guidelines on Asset Reversions (May 23, 1984), at http://www.pbgc.gov/plan_admin/termpol/erisa.pdf.

employees and put the risk onto the shareholders who are in a position to diversify and bear more of the risk. Ippolito implies that giving employees a less-risky benefit would enable employers to pay less in the way of other compensation.

I think the answer to this puzzle may be hidden by the fact that there is an assumption built into the model Ippolito is using that produces this result. This is the assumption that the total compensation of employees is, in fact, exogenously determined, so that any loss in value of the pension to employees due to the increased riskiness of the pension plans must be made up in higher salary or other compensation.¹²

The assumption is a convenient one because it prevents Ippolito from having to get into the question of whether there was some redistribution of value from employees to shareholders and whether there is a fairness or equity question to be considered about employers doing this. Because he assumes that the employees are compensated somewhere else for the increase in risk, he does not question whether there was some external change in the terms of trade that has allowed employers to systematically redistribute cost and risk away from capital and onto labor in recent decades. He assumes, in effect, that the employer's decision comes down to choosing the compensation package that meets the workers minimum compensation demands. No value can be simply usurped from employees according to Ippolito's assumptions because, if value is taken from one pocket, it must be put back into employees' pockets somewhere else in the compensation package.

Ippolito provides no empirical evidence for this assumption but I would like to see some evidence of it, if it exists. I find the assumption very questionable. I think the assumption is actually contradicted by the internal logic of Ippolito's own model. This brings me to the second point I want to make about Ippolito's Article. Employees, as Ippolito points out, have both pension assets and firm-specific human capital at risk in the corporate enterprise. I am using the term "firm-specific human capital" the same way Ippolito uses it—to mean the value of a lifetime job at a current employment minus the present value of the next best alternative. It is the value an employee gets by staying put and not losing her job versus what

12. Ippolito makes this assumption in reverse:

Workers do not obtain pensions for free. They sacrifice cash wages in exchange for the pension promise. . . . If one starts with the assumption that workers sacrifice wages . . . to obtain a pension with certainty, then they require a rebate . . . in consideration of accepting the risk that they might receive a lesser amount upon bankruptcy [of the employer].

See Ippolito *supra* note 1, at 1257.

she would have to take in her second best employment. Ippolito seems to agree that this is positive and it is nontrivial.

I would like to suggest, however, that it is more than nontrivial. One of the things Ippolito says is that the pattern of asset accumulation and risk bearing in one's pension plan has a curving shape where the risk is low at the beginning and low at the end, but high in mid-employment. That same pattern applies to the risk of loss of firm-specific human capital, except that the firm-specific human capital component, I have some reason to believe, is typically several times the value of the pension assets at risk.

My basis for believing that the value of firm-specific human capital at risk in most corporations is quite large comes from empirical studies that have shown that displaced workers who lose their jobs through no fault of their own—as through plant closings, for example—find that their next best alternative jobs pay about 10% to 15% less.¹³ This means that an employee who gets laid off loses an asset that had been generating about 10-15% of his income each year. That asset just disappears.¹⁴

I do not know what the typical contribution of employers to employee pension plans is, but my guess is that it is much smaller than 10% to 15% of the employees' wages. Say, for example, it is 5% of employee wages. Then suppose that the present value of the average at-risk pension benefit is, say \$50,000. By comparison, the asset that employees may lose if they lose their firm-specific human capital is two to three times as much: \$100,000 to \$150,000.

So I think employees need to be added to Professor LoPucki's list of residual-risk bearers.¹⁵ Employees are important residual-risk bearers in corporations not only for firms in bankruptcy but for firms that are going concerns.

I should let Ippolito speak for himself, but my guess is that he will respond that employees obviously must be paid some fair rate of return and so we have to assume that in the long run equilibrium they are going to be compensated if they have to bear more risk. But my answer is that the variance around this equilibrium rate of return, both for employees and

13. See BLAIR, *supra* note 2, 265 nn.38–42; see also Robert C. Topel, *Specific Capital and Unemployment: Measuring the Costs and Consequences of Job Loss*, in *STUDIES IN LABOR ECONOMICS IN HONOR OF WALTER Y. OI* 118–214 (Allan H. Meltzer & Charles I. Plosser eds., 1990) (finding that, in a large sample of workers who had lost their jobs through business closings and layoffs in the mid 1980s, the average worker earned 14% less on his next job).

14. See *supra* note 13 and sources cited therein.

15. See Lynn M. LoPucki, *The Myth of the Residual Owner: An Empirical Study*, 82 WASH. U. L.Q. 1341 (2004).

for shareholders, is very high. We know it is high for shareholders¹⁶ and I suspect that it is extremely high for employees also. So, in essence, what is happening is that at any given corporation, at any given moment, there may be a common pool of economic “rents,” or “quasi-rents” if you want to get technical about it. This pool of rents is up for grabs in a corporation at any time. Sometimes employees get “supernormal” returns, and sometimes shareholders get “supernormal” returns, and sometimes both do.

As a consequence, in practice, the variance is so high that one cannot really determine over any given month or year whether any particular group of employees or any particular group of shareholders are being “fairly compensated.” Rather, we should more realistically understand that we have a total pool of assets, and it is simply up for grabs, and whoever has power in a given situation can grab a bigger piece of it. The significance of this understanding of how rents are shared in corporate enterprises is that there is nearly always a lot of room for employees to take more than their long-run equilibrium competitive return, at the expense of shareholders. In addition, there is always the opposite possibility that shareholders can take more than their long-run equilibrium competitive return, at the expense of employees.

The big difference is that in the field of law and economics we have a huge body of literature and legal analysis that is concerned with the problem of employees taking more than their appropriate or “fair” share. In fact, we have a special name for this problem: we call it a “principal agent” problem.¹⁷ And we refer to the costs to shareholders from employees taking more than their share, or the costs that are imposed on shareholders from trying to prevent employees from taking more than their fair share, as “agency costs.”¹⁸

We do not have a similar name for, and there is almost no literature on, the problem of shareholders taking more than their fair share. In fact most corporate law scholars who have been trained in jurisprudence of law and economics do not even recognize the latter as a problem.¹⁹ This is because

16. See BREALY ET AL., *supra* note 7, at 267–72 (where the standard deviation of common stocks is cited as 20.3, compared to 3.2 for Treasury bills and 9.2 for long-term government bonds).

17. The literature on agency problems in the theory of the firm is enormous, going back to Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). See also Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 247 n.1 (1999) (listing some of the principle articles in that literature).

18. See Jensen & Meckling, *supra* note 17.

19. See Margaret M. Blair, *Firm-Specific Human Capital and Theories of the Firm*, in

we have assumed that employees are protected by contract and that shareholders are the only residual-risk bearers. If we assume that employees always get their equilibrium level of total compensation as Ippolito has done, whether it comes in the form of pension benefits or wages or any other type of compensation, this just contributes to the tendency of law and economics scholars to assume away the problem of capital getting more than its fair share of corporate rents at the expense of employees.

I see no evidence in Ippolito's Article that convinces me that, in fact, employees have been compensated for the additional pension risks they now bear under the new defined-contribution plans. Instead, I think there were some macroeconomic shifts in which power shifted from labor to capital, somewhere around the early 1980s, and that we are still playing that shift out. Capital has successfully grabbed a larger share of total output for most of the last 25 years, and employees, implicitly, lost what capital gained.²⁰ I see no reason to believe that labor is being compensated in other sorts of ways.

EMPLOYEES & CORPORATE GOVERNANCE 71 (Margaret M. Blair & Mark J. Roe eds., 1999) (discussing the asymmetric nature of the canonical principal-agent problem).

20. Although there is significant evidence to prove a declining trend in labor's share of GDP, there has been a marked decline in the quality of labor's share. Wages play a less prominent role in employee remuneration, being replaced by much more speculative pension benefits, health insurance, and stock bonus plans. *See* CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2006–2015, at fig.2-12 (2004), at <http://www.cbo.gov/showdoc.cfm?index=6060&sequence=3>.