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The Report of the President's Cabinet Committee on Private Pension Plan Regulation: An Appraisal

Thomas B. Ridgley
University of Michigan Law School

The Report of the President's Cabinet Committee on Private Pension Plan Regulation: An Appraisal

The growth of private employee pension plans in the American economy is astonishing. From 1953 to the end of 1964, the accumulation of assets of private pension funds has grown from 16.9 billion dollars to 75 billion dollars, with a projected accumulation of 225 billion dollars by 1980.[1] At present, private retirement plans cover approximately 25 million workers, which is one-half of all employees in private non-farm establishments.[2] Moreover, unions increasingly stress both the creation of pension plans where none exist and increased benefits from current plans. Thus, during the recent United Auto Workers negotiations the union sought and received extensive increases in benefit payments.[3] Finally, unions are also attempting to establish pooled joint retirement funds where smaller companies are involved, thereby permitting employers who previously could not afford to maintain funds to provide pension benefits for their employees.[4]

Numerous factors have contributed to pension plan growth. During and since World War II, high corporate taxes coupled with a deduction allowance for contributions to pension plans have permitted pension plan establishment and maintenance at a relatively low net cost to the employer.[5] In addition, in 1948, *Inland Steel Co. v. NLRB*[6] held that welfare and pension matters were bargainable issues, giving impetus to the labor drive to obtain extensive employee security programs. Perhaps most important (albeit difficult to substantiate) has been a growing demand by workers for economic security during retirement. Private pension plans have filled this demand for a substantial part of the work force; coupled with Social Security benefits, private pension benefits may well provide adequate retirement incomes for those covered.[7]

1. President's Comm. on Corporate Pension Funds and Other Private Retirement and Welfare Programs, Public Policy and Private Pension Programs—Report to the President on Private Employee Retirement Plans xiv (Jan. 29, 1965) (hereinafter cited as Cabinet Comm. Report); U.S. News & World Report, June 17, 1963, p. 106.

2. Cabinet Comm. Report 2.

3. At Chrysler, retirement income is now $4.25 a month per year of credited service, up from $2.80 under the old contract.

4. Wall Street J., Oct. 27, 1964, p. 1, col. 6.

5. This is only one of several reasons for the extensive growth of pension plans suggested by the Subcommittee on Welfare and Pension Funds of the Senate Committee on Labor and Public Welfare, *Final Report on Welfare and Pension Plan Investigation,* S. Rep. No. 1734, 84th Cong., 2d Sess. 12 (1956) (hereinafter cited as the Douglas Report).

6. 170 F.2d 247 (7th Cir. 1948), *cert. denied,* 336 U.S. 960 (1949).

7. See 58 Lab. Rel. Rep. ¶ 153 (Feb. 22, 1965).

As private retirement plans have grown in number and importance, so has federal legislation regulating their use. Nevertheless, considering the economic and social importance of pension plans, the degree of federal regulation is and has been minimal. This predominantly laissez-faire attitude may be on the wane, however. In 1962 President Kennedy established a Cabinet Committee to review pension plan growth and behavior and to make recommendations for further federal control;[8] on January 29, 1965, President Johnson released the final report of this Cabinet Committee. The report contains recommendations which suggest fairly extensive federal regulation of several aspects of pension planning and administration.

I. Present Federal[9] Regulation of Pension Plans

To realize the significance of the Committee's proposals, it is necessary to understand the scope of existing legislation. The most important extant legislation is the Welfare and Pension Plans Disclosure Act.[10] Because of the continued growth of welfare and pen-

8. The Chairman of the Committee was Secretary of Labor Wirtz and members were the Secretary of the Treasury, Secretary of Health, Education and Welfare, the Director of the Budget Bureau, the Chairman of the Board of Governors of the Federal Reserve System, and the Chairman of the Securities Exchange Commission.

9. Section 16 of the amended Disclosure Act provides that nothing in the act should be construed as preventing any state from obtaining additional information (beyond that required by the Disclosure Act) on welfare and pension plans or from otherwise regulating such plans, 76 Stat. 38 (1958), 29 U.S.C. § 309 (1958). Although the Disclosure Act allows the states to regulate pension plans as they choose, at present legislation exists only in the form of reporting and disclosure and only five states have this type of legislation: Connecticut, Massachusetts, New York, Washington, and Wisconsin. Although the states have chosen not to regulate pension plan activity, several authorities insist that the states are best equipped to deal with the problem of pension plan regulation due to the availability of state administrative machinery and their proximity to the operations of the funds. See, *e.g.*, Vladeck, *Public Regulation of Pension Plans*, N.Y.U. 10th Ann. Conf. on Labor 143, 155 (1957).

10. 72 Stat. 997 (1958), as amended, 29 U.S.C. §§ 301-09 (Supp. V, 1964). The Labor Management Relations Act § 302, 61 Stat. 157 (1947), as amended, 29 U.S.C. § 186 (Supp. V, 1964) contains minor regulation of welfare and pension plan activity. Section 302 is a general prohibition against payment of money or other things of value by an employer to a representative of its employees or a labor organization representing its employees. One of several exceptions to this general prohibition is payment to trust funds established by a representative of the employees, § 302(c)(5). However, the plan must fulfill the following requirements before it is exempt from the general prohibition: the sole purpose of the trust must be to benefit employees of the employer or their dependents, the basis on which payments are to be made must be specified in a written agreement, the employees and employer must have equal representation in the administration of the funds, there must be an annual audit of the funds available for inspection at the principal office of the trust fund, and payments intended to be used for pensions and annuities must be made a separate fund and cannot be used for any other purpose. The act proved to be totally ineffectual with respect to welfare and pension plan regulation and disclosure. Since the act covers only funds passing from the employer to the employee representative or union, most plans are not covered by the act. Nearly all plans are unilaterally instituted by employers or unions. Even if the plan were within the purview of § 302(c)(5), there is no penalty for maladministration of the funds, no prohibition of administrative committees paying themselves excessive

sion plans throughout the 1950's and because of evidence uncovered by congressional investigations of looting and mishandling of pension funds, it became apparent that legislation was necessary to protect the equities of participating employees.[11] In 1958, Congress concluded that the best way to attack these abuses was by reporting and disclosure of administrative information to interested parties.[12] However, the 1958 Act proved to be ineffectual. Because the act required only limited reporting of fund administration and failed to provide the Secretary of Labor with enforcement or investigative powers, its effectiveness was determined solely by the self-policing and self-appraisal of plan beneficiaries.[13] Because of this lack of

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salaries, no safeguard against other forms of self-dealing by the committee, and no remedy for abuse of trust purposes. The annual report requirement is also ineffectual because the act fails to specify the information to be included in the report; the usual report is not sufficiently detailed to disclose the nature of the fund's disbursements. In addition, the reports were not given the wide distribution essential for effective disclosure; the act requires only availability at the plan's principal office.

The Disclosure Act provides criminal sanctions for violation of its provisions. In 1958, Congress added several new sections to the Federal Criminal Code making explicitly illegal theft or embezzlement from employee benefit plans, knowingly making false statements or concealing facts in relation to documents required by the Welfare and Pension Plans Disclosure Act, and receipt or offering of kickbacks, gifts or commissions for influencing a plan's actions. Penalty for convictions is a $10,000 maximum fine, a maximum of three or five years imprisonment (depending on the offense), or both the fine and imprisonment. The maximum imprisonment for embezzlement or theft of funds and for false statements or concealment of facts is five years; for receipt or offering of kickbacks, gifts or commissions it is three years. Embezzlement and theft provision, 18 U.S.C. § 664 (Supp. V, 1964); making false statements and concealing facts, 18 U.S.C. § 1027 (Supp. V, 1964); receipt or offering of kickbacks, gifts or commissions, 18 U.S.C. § 1954 (Supp. V, 1964). One of the problems in the concept and administration of the Disclosure Act is that the reported and disclosed information never reaches participants of the plan unless they themselves expend effort to get the annual report. Even then, most employees probably could not interpret the reported information. Section 10 of the Disclosure Act allows the Secretary of Labor to publish any information or data contained in plan descriptions and annual reports where it would protect the interests of plan participants. To a certain extent, this facilitates the dissemination of the information, but the decision to publish is made by the Secretary of Labor and not by interested parties. Even with the amendment, an employee would have to be highly motivated to inspect the administration of his pension plan before the information would come to his attention.

11. S. Rep. No. 1440, 85th Cong., 2d Sess. 3, 11 (1958). Some of the worst abuses involved the following insurance practices: exorbitantly high commissions paid to individual agents in order to acquire adoption of the particular plan over which the agent had control; excessive administrative fees; unequal treatment of policyholders; placing the interests of policyholders above those of the beneficiaries; and activities of unscrupulous brokers and agents including embezzlement of premiums, sometimes in collusion with union or management officials.

12. Douglas Report 8; H.R. Rep. No. 2283, 85th Cong., 2d Sess. 2 (1958).

13. Under §§ 9(b) and (d) of the 1958 Act, plan participants could sue to enjoin violations of § 8, the publication provision, in the federal district courts or could sue any administrator of a plan for damages who failed or refused, upon written request of a participant, to make publication to him within 30 days of the request. Damages were $50 a day from the date of failure or refusal. From 1958 to 1962, however, even in light of the evidence of extensive looting and mishandling of funds prior to 1958 and of the failure of many plan administrators to file required reports with the

power, it is not surprising that at least one-third of those administrators required to file descriptions and reports failed to do so.[14]

In 1962, important amendments[15] to the act became effective, and it is in this amended form that the Disclosure Act exists today. The basic reporting and disclosure concepts of the act were not changed. However, the Secretary of Labor was given the powers essential for producing compliance with the act: authority to conduct investigations, subpoena witnesses and records, and bring suit in the federal district courts to enjoin temporarily or permanently actions violative of the act.[16] Although the Disclosure Act is considerably strengthened by these amendments, it remains only a device for eliciting information. Consequently, the question of whether some form of positive regulation is needed, whether there still exist more subtle but equally destructive threats to the security of participating employees,[17] remains.

The only present regulation of the scope and administration of private pension plans is found in the Internal Revenue Code. While the threat of criminal prosecution provides the deterrent against violation of the Disclosure Act, the enforcement arm of the Code lies in the power of the Internal Revenue Service to grant or disallow the "qualified" status of a pension plan. Qualification of a pension plan is usually highly desirable because it provides extensive tax advantages to both the employer-trustor and the employee-beneficiary: employers' contributions are deductible as ordinary and necessary business expenses;[18] employer contributions are not taxable as part of the employees' gross income in the taxable year where paid into the fund but rather are taxed when the employee receives the benefits, which usually occurs after retirement when an employee's tax rate is lower;[19] and, finally, any income earned by a "qualified" trust is exempt from tax to the trust.[20]

Secretary of Labor, apparently only one such suit was brought by plan participants. BNA, FEDERAL-STATE REGULATION OF WELFARE FUNDS 28 (1962).

14. McConnell, *Recent Developments in the Planning and Administration of Health and Welfare Plans*, N.Y.U. 14TH ANN. CONF. ON LABOR 351, 360 (1961). In recommending possible amendments to the 1958 Act, Secretary of Labor Mitchell stated: "Although it is not possible to state precisely the magnitude of under-reporting, it does not appear unreasonable to believe that it would run into the thousands." CCH LABOR WEEKLY SUMMARY No. 630, at 17 (Aug. 23, 1960).

15. 72 Stat. 997 (1958), as amended, 29 U.S.C. §§ 301-09 (Supp. V, 1964).

16. Disclosure Act, § 9(d)-(f), 29 U.S.C. §§ 308(d)-(f) (Supp. V, 1964).

17. Eight days after he praised the 1962 amendments and signed them into law, President Kennedy created the committee whose report has just been made public. Obviously, he did not envision reporting and disclosure legislation as the ultimate scope of federal pension plan regulation.

18. INT. REV. CODE OF 1954, § 404(a), but such deduction shall not exceed five per cent of the compensation paid to all employees (§ 404(a)(1)(A)).

19. INT. REV. CODE OF 1954, §§ 402(a)(1), 403(a)(1).

20. INT. REV. CODE OF 1954, § 501(a).

To merit these tax advantages a plan must meet several specific requirements. First, the plan must be created and its accumulated funds used for the exclusive benefit of employees or their beneficiaries,[21] and no part of the corpus or income of the funds may revert to the employer.[22] Moreover, at least seventy per cent of an employer's employees with five years or more service must be included in the plan, or, if less than seventy per cent are participants, the eligibility classification of employees must not discriminate in favor of employees who are officers, shareholders, or supervisors.[23] Similarly, once the plan is in effect, there may not be discrimination in favor of officers, shareholders, or supervisors in determining eligibility requirements, contributions, or receipt of benefits.[24]

Since these are the only requirements for plan qualification, however, it is apparent that even the regulation of private retirement plans by the Revenue Code is minimal, and it merely assures that the plans are established and maintained for the exclusive benefit of the trustor's employees, that funds will properly flow to designated beneficiaries, and that the employer will not use nontaxable funds as part of its general corporate assets or for a "key man" incentive system for its executive employees. All other policy decisions as to plan content and administration have been left to the company's discretion.

II. Committee Proposals

Legislative adoption of the Cabinet Committee proposals would end discretion in several areas of pension planning and administration. The most significant recommendations propose federal regulation of vesting,[25] funding[26] and investment[27] practices. The Committee's justification for federal intervention is their conception of private pension plans as a supplement to Social Security, indirectly subsidized by special federal tax treatment.[28] The Committee found that the federal government loses at least one billion dollars in revenues each year because of the special treatment given qualified

21. Int. Rev. Code of 1954, § 401(a)(2).
22. Int. Rev. Code of 1954, § 401(c)(2).
23. Int. Rev. Code of 1954, § 401(a)(3)(A) & (B).
24. Int. Rev. Code of 1954, § 401(a)(4). In order to determine whether the plan is one which should be "qualified," the IRS requires that each employer file with its return for the year in which it seeks a deduction for plan contributions a comprehensive questionnaire which reveals whether the requirements for qualification were met. Treas. Reg. § 1.404(a)(2) (1956), as amended, T.D. 6676, 1963-2 Cum. Bull. 41.
25. See text accompanying note 31 *infra*.
26. See text accompanying note 43 *infra*.
27. See text accompanying note 57 *infra*.
28. Cabinet Comm. Report 15. Undoubtedly, instead of relying on indirectly regulating pension plans through amendments to the Internal Revenue Code, the Committee could have recommended direct regulation of pension plan activity by relying on the commerce clause for constitutional basis as was done in the Disclosure Act.

plans[29] and concluded that "the purpose of [these] tax concessions granted by the Federal Government to qualified pension plans is to encourage the growth of sound plans which supplement the public retirement security system."[30] To assure the federal government of the soundness of the plans and to implement effective federal control, the Committee has recommended that the present pension plan qualification requirements of the Revenue Code be amended to enable enforcement of the proposed regulatory standards, with the consequence that specific minimum vesting, funding, and investment criteria would have to be met in order to qualify for the tax advantages.

A. *Minimum Vesting Rights*

Probably the most controversial Committee recommendation concerns the establishment of a minimum vesting requirement. Succinctly, a vested plan is "one in which an employee receives a benefit from the fund although he has not reached the full requirements of age or service before separating himself from the plan or the employer who established it."[31] The growing popularity of vesting provisions is manifest in the Bureau of Labor's statistics; in 1952 only twenty-five per cent of the plans studied had vesting clauses, while in 1963 two out of three plans studied had vesting provisions.[32]

Although there is an apparent trend toward vesting of pension rights without government intervention, the Committee considered vesting to be of such importance that it did not want the decision of inclusion or exclusion of vesting provisions to be made by private parties, and consequently it proposed that inclusion of a minimum vesting provision be a qualification for favorable tax treatment. Specifically, as a minimum requirement, deferred graded vesting[33] with fifty per cent vesting after fifteen years and full vesting after twenty years service was recommended.[34]

Two primary reasons are advanced for establishing vesting provisions. One is based on what may be characterized as the union

29. *Id.* at 17.

30. *Id.* at 51.

31. HARBRECHT, PENSION FUNDS AND ECONOMIC POWER 53 (1959). One of three types of vesting provisions may be used: immediate full, deferred full, and deferred graded. Immediate full vesting gives the employee the right to all accrued pension benefits at the termination of his employment regardless of the length of employment. This type of vesting provision is rarely used. Deferred full vesting gives the employee a right to *all* accrued benefits after he has met specified requirements, *e.g.*, reached age forty and completed ten years of service. Deferred graded vesting differs from deferred full vesting in that the employee acquires the right to a stipulated *percentage* of accrued benefits upon achieving specified age and service conditions but this percentage also increases until the employee eventually meets the maximum requirements when his pension becomes fully vested.

32. BNA, LABOR POLICY AND PRACTICE BULLETIN TO MANAGEMENT 4 (Oct. 29, 1964).

33. See note 31 *supra*.

34. CABINET COMM. REPORT 42.

concept of the function and nature of pensions. Unions assert that employees earn the right to pensions as they work because they are working for a lower straight hourly wage in order to receive pension benefits.[35] Therefore, employees should have vested rights in what they have earned. A second reason frequently suggested for the use of a vesting provision is that pension plans without vesting provisions tend to impair labor mobility by tying the worker to the job in which he has pension credits he would lose if he leaves. On the other hand, management representatives attribute the existence of a pension plan to different purposes. As the Committee itself pointed out, "private retirement plans had their origins in retaining valuable employees, in reducing labor turnover and its attendant costs, and in rewarding long service."[36] These business purposes behind the creation of pension plans are still viable today.

Both the union and management positions have merit, and it seems infeasible to resolve the propriety of a minimum vesting requirement by weighing the relative strengths of these two diverse concepts. However, when the probable practical effect of a vesting requirement is examined it is doubtful that the proposal would be either a wise or effective law. In some industrial situations, primarily in the so-called depressed industries,[37] the additional cost to plans resulting from a vesting requisite for qualification would mean lower benefits or reduced coverage.[38] In addition, increased costs of a vesting provision might well discourage the establishment of new plans. For these reasons, the President's Advisory Committee on Labor-Management Policy,[39] after reviewing a preliminary report by the Cabinet Committee, concluded that while supporting "the general principle of vesting in private pension plans . . . it would be unwise to require some mimimum standard of vesting for tax approval."[40]

While it might be expected that union leaders would strongly support a minimum vesting requirement, the views expressed by two prominent union officials, as Advisory Committee members, indicate that this is not true. Anthony Boyle, president of the United

35. AFL-CIO, PENSION PLANS UNDER COLLECTIVE BARGAINING 19-21 (1953).

36. CABINET COMM. REPORT 1.

37. *E.g.*, those industries where competitive products have seriously diluted the market, such as the coal mining industry, or those in which there is a continually low margin of profit.

38. See note 51 *infra*.

39. The Advisory Committee, composed of leaders of industry and labor, at the request of President Kennedy reviewed the preliminary draft of the Cabinet Committee's *Report* and made recommendations to the President as to how the *Report* might be improved. These suggestions were forwarded to the Cabinet Committee.

40. *Report to the President from the President's Advisory Committee on Labor-Management Policy on the Recommendations by the Cabinet Committee on Corporate Pension Funds and Other Private Retirement and Welfare Programs*, in CABINET COMM. REPORT, app. D, at 3 (hereinafter cited as REPORT, app. D).

Mine Workers, and David Dubinsky, president of the International Ladies' Garment Workers' Union, voiced opinions against both minimum funding and vesting requirements. Dubinsky, articulating reasons in opposition, stated that a vesting requirement may "unduly burden the maintenance of existing plans or hamper the establishment of new plans, and may interfere with decisions regarding the allocation of resources available for pension benefits."[41] It is likely that other union leaders, especially those representing unions serving depressed industries, will agree because of the increased cost of vesting coupled with the inability of a depressed industry to absorb this extra cost without depressing employee coverage or the level of benefits. In contrast, Walter Reuther, whose union serves probably the most prosperous industry in the country, supports the enactment of a vesting requirement and suggests that only ten years of service be the standard for deferred vesting.[42] The threat of a cutback in plan coverage or the level of benefits is seemingly insignificant to him and to his union since from the latest contract settlement the UAW sought and received extensive increases in the level of benefit in addition to a provision granting full vesting of pension rights after ten years of service.

Because the consequence of a minimum vesting requirement would be inequitably harsh on employees in some industries, the existence of a vesting provision should be decided at the bargaining table. When both parties to an agreement acknowledge that it is not in their best interest to include a vesting provision in a pension plan, there must be valid reasons for the decision, and this conclusion should be recognized without the discriminatory penalty of denial of tax advantage qualification.

B. *Minimum Funding*

Funding of pension plans is the process of accumulating, usually over a period of many years, assets in a pension fund which are irrevocably earmarked to pay benefits to plan participants in the future.[43] In an unfunded pension plan, the employer does not segregate assets for payment of retirement benefits when they fall due but he normally does adopt a bookkeeping practice to indicate the accumulation of surplus for that purpose. A plan is fully funded, on the other hand, when the accumulated assets at all times are at least equal to accrued liabilities. An intermediate type of funding is the practice of partially funding accrued liabilities, and it is disagreement over the degree of partial funding sufficient to in-

41. *Id.* at 14.
42. *Id.* at 16.
43. *Id.* at 30.

sure reasonable security of participant benefits which generates the basic minimum funding controversy today.

Accrued liabilities represent the present value of future benefits owing to employees. Definitionally, accrued liabilities are composed of three basic components: current service liabilities, past service liabilities, and liabilities from retroactive increases in the level of benefits, if any.[44] Current service liabilities represent the present value of future benefits which are based on employee service performed during a particular year, usually the current year. Past service liabilities represent the present value of future benefits which are based on employee service performed prior to the inception of the plan. Upon establishment of a plan, there will no doubt be a number of older employees who have been with the company many years prior to the creation of the plan. If an employee has only a few remaining years of service before retirement, contributions by the employer calculated on the basis of this short period of future service will be inadequate to establish a reasonable pension. To rectify this result, many plans grant a credit for past service to these employees.[45] Finally, liabilities from retroactive increases in the level of benefits represent the present value of future benefit increases which are based on employee service performed prior to the inception of the increase.[46]

44. Current service liabilities always exist for the trustee of an active pension plan. On the other hand, past service liabilities and liabilities from retroactive increases in the level of benefits may or may not exist, depending upon the trustee's determination to grant the benefits giving rise to these liabilities.

45. Of course, the more credit extended for past service, the more costly the plan will be. Thus, as a practical matter, limitations may be placed on how much past service will be acknowledged. This may be done either by denying credit for years of service beyond a specified number prior to the inception of the plan or by refusing credit for service prior to a specified age of the employee.

46. The meaning of these terms as used in the minimum funding context may be clarified by an example. Assume that an employee has worked for a company since 1945. In 1950 the company instituted a pension plan, establishing as the level of benefit $3.00 a month of retirement income for each completed year of service, including service prior to the plan's inception. At the end of 1964, the company retroactively raised the level of benefits to $4.00 a month of retirement income for each completed year of service.

At the inception of the plan in 1950, the company had a past service liability which was the then present (1950) value of the right of the participant to receive $15 a month of pension income upon retirement (five years past service times $3.00), and represents that proportion of total retirement income attributable to employee service performed prior to the inception of the plan. Present value, of course, simply represents the amount which, when presently invested at a specified interest rate, will produce the promised amount of income at retirement.

From 1950 to the end of 1964, the current service liability for each year would be the present value of the right to receive $3.00 a month of retirement income (one year of current service times $3.00), and is that portion of the employee's total retirement income attributable to employee service performed during the current year.

At the end of 1964, the level of benefits was increased by $1.00 a month retirement income for each completed year of service. The increase had both a retroactive and prospective impact on the company's liabilities. The liability from the retroactive

An existing minimum funding law is incorporated in the Revenue Code and requires total contributions sufficient to cover current service liabilities and the interest charge on other unfunded components of accrued liabilities.[47] However, this qualification standard applies only to plans in which at least one of the company's twenty-five highest paid employees participates. Thus, the present law is not directed at assuring adequate funding generally, but rather is designed to prevent discrimination in favor of near-retirement-age, high-salaried employees by termination of the plan after the favored employees have received their full pension benefits, thus leaving insufficient funds to pay the other participants.

The Committee argued that the present tax law allows the employer too much discretion in selecting how to fund its accrued liabilities and that this flexibility may, and often does, lead to inadequate funding.[48] The Committee concludes that if the plan is inadequately funded it may turn out to be an empty or only partially fulfilled promise of security in retirement. Consequently, the Committee recommended that, with regard to stated benefit plans[49] a minimum funding requirement for *all* plans which are to qualify for advantageous tax treatment be enacted. Specifically, full funding of all current service liabilities and full amortization of all accrued liabilities would be mandatory, and past service credits would have to be fully funded within thirty years from the inception of a new plan or, in existing plans, within thirty years from the enactment of the proposed requirement. Retroactive increases in the level of benefits would have to be fully funded on the same basis as

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increase in the level of benefits is the present value of the right to receive $14 a month of retirement income (fourteen years of past service prior to the retroactive increase times $1.00, the increase in the level of benefits). The prospective effect will be that the current service liability for 1965, and subsequent years, will now be the present value to receive $4.00 a month of retirement income (one year of current service times $4.00).

47. Treas. Reg. § 1.401-4(c) (1956), as amended, T.D. 6675, 1963-2 CUM. BULL. 151.

48. CABINET COMM. REPORT 50. As one commentator has suggested, many financial officers of companies are not concerned so much with the ultimate cost of the plan as with keeping current expenditures at a minimum. Hines, *Split-Funding and Insurance Company Plans*, N.Y.U. 10TH ANN. CONF. ON LABOR 191, 198 (1957).

49. The stated benefit plan is one which promises the employee a specific retirement income (*e.g.*, a specific value per month times the number of years of service). A second type of pension plan is the fixed contribution plan. An example of such a plan would be a promise by the employer to contribute $.05 for every hour worked by participating employees. The employee benefits received would then be those which the combination of contributions and yield therefrom would produce.

As to fixed contribution plans, the Committee proposed the general requirement that contribution commitments should be realistically related to the benefits promised and actually paid. As a practical matter, this suggestion has little meaning. If the parties to a collective bargaining agreement are dealing with a fixed contribution plan, both will have actuarial estimates of what level of benefits the contribution will provide; neither party merely speculates as to the likely benefits which will be forthcoming.

past service credits except that they would have to be fully funded within thirty years after the event giving rise to the liability. Finally, the Committee suggested there be a certification of the funding method of each new plan at its inception and a periodic investigation thereof at least every three years, both by an actuary with acceptable professional qualifications.[50]

The President's Advisory Committee, which rejected the vesting proposal, endorsed a minimum funding requirement. There is, however, extensive opposition to the funding proposal, both by labor and management. Both labor leaders on the Advisory Committee who opposed a vesting requisite for qualification also opposed the funding requirement. Again, the reason postulated was the cost to existing plans and retardation of the creation of new plans. The Cabinet Committee itself admitted that the passage of the funding proposal might raise the cost of plans more than ten per cent or that the passage of both minimum vesting and funding requirements together might do so.[51] Anthony Boyle indicated that if the minimum funding requirements were applied to the UMW Welfare and Retirement Fund, "the reserve for accrued benefits would need to be increased by several times or, in the alternative, benefit levels would need to be slashed correspondingly, although no imperative need is shown for either."[52] David Dubinsky pointed out that plans which are not fully funded can nonetheless be actuarily sound, especially in the case of multi-employer plans where the likelihood of termination of such plans is remote.[53]

Management's basic criticism of the requirement is that it would place the employer in an economic straitjacket by taking away the present flexibility of funding more in good years and less in lean years. In the view of one actuarial consultant, pensions must be looked upon as part of the compensation of employees. In the use of other forms of compensation, such as bonuses[54] and profit-sharing plans,[55] the employer has considerable flexibility in determining what its annual payroll cost will be; he therefore concludes that it is not reasonable to restrict the flexibility of pension costs.[56]

The justification for more fully funded plans is apparent; em-

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50. CABINET COMM. REPORT 53.

51. *Id. at* CABINET COMM. REPORT 54.

52. REPORT, App. D, at 13.

53. *Id.* at 14.

54. If a company has a profitable year there is presumably no limitation on employee bonuses it may grant within the limits of its profit margin and common-law waste restrictions.

55. Companies with a defined profit-sharing plan usually have a cost variable of from 30% of payroll to nothing, giving the employer extensive flexibility in deciding its profit-sharing cost for a given year. 58 LAB. REL. REP. 151 (Feb. 22, 1965).

56. Robert Wishart, senior associate of George B. Buck, Consulting Actuaries, as part of a panel discussion of the Committee's report at the American Management Association's Personnel Conference. *Ibid.*

ployees should have reasonable assurance that promised retirement income will be forthcoming in the anticipated amount. Moreover, while minimum vesting would legislatively grant employees rights which had not been given voluntarily by employers, minimum funding would merely give employees greater assurance of benefits already promised. As with minimum vesting of pension rights, however, the question is whether the imposition of a uniform standard of funding is appropriate. It would seem that, in light of the statements opposing the proposal, the increase in costs to pension plans resulting from the minimum funding requirement would be at least as great as that resulting from the vesting requirement. The increased costs may force some employers to terminate present plans or lower the level of benefits, thereby eliminating or reducing the retirement income of participating employees. Funding levels, as well as vesting provisions, are more properly determined by the parties to the collective bargaining agreements. To force minimum uniformity on all plans would be to ignore the wide diversity in ability of employers to fund plans at the proposed required level and still maintain existing benefits.

C. *Investment Regulation*

Pension trustees have nearly limitless freedom in investing the plan funds.[57] The Disclosure Act expressly avoids regulation of fund investment;[58] and the tax law generally does not attempt to regulate investment of pension funds.[59] Possibly the prohibition in the Code against fund corpus or income reverting to or being used by the employer may initially serve as a restriction by prohibiting at least some self-dealing investment in the trustor corporation. However, while disclosure must be made of the reasons for investment in stock or securities of the employer,[60] there is no general prohibition of self-dealing investment. If the Internal Revenue Service is satisfied that the plan is operated for the exclusive bene-

57. While restrictions on benefit plan trustee discretion may, of course, be imposed by the trust instrument, most corporations allow the trustee almost complete freedom on the theory that greater investment discretion means a higher yield. Thus, a New York State Banking Department study showed that of 1,024 bank-trusteed plans investigated, 702 had *no* restriction on investment discretion. Business Week, Jan. 31, 1959, p. 97. As one commentator declared: "If the trust fund agreement does not contain substantial investment restrictions, previous experience indicates that a trust fund can earn at least ½ to 1 per cent more than when it is so limited." Kearshes, *Methods of Funding in Pension Planning—The Trustee Plan*, N.Y.U. 10TH ANN. CONF. ON LABOR 205, 214 (1957).

58. Disclosure Act § 9(h), 29 U.S.C. § 308(h) (Supp. V, 1964).

59. Treas. Reg. § 1.401-1(b)(5)(i) (1956), as amended, T.D. 6722, 1964-1 CUM. BULL. 144. No specific limitations are provided in § 401(a) with respect to investments which may be made by the trustees of a trust qualifying under section 401(a).

60. Treas. Reg. § 1.401(b)(5)(ii) (1956), as amended, T.D. 6722, 1964-1 CUM. BULL. 144.

fit of the employees, the fund will not lose its tax status.[61] Moreover, unless there is blatent self-dealing,[62] or unless the most elementary investment principles are disregarded,[63] the pension fund will not lose its "qualified" status for any investment practice.

Recently, some financial experts anticipated that the first significant regulation of pension plans would be in the form of restriction of investment discretion.[64] The reason for this belief is the growing tendency of administrators to move from low-yield to higher yield, but often more speculative, investments. Ten years ago, generally accepted principles of pension fund investment were maintenance of the safety of principle, assurance of yield, and liquidity of funds,[65] and government bonds were the focal investment of all plans. However, from 1951 to 1963, common stock investments increased from 11.4 per cent to over 41 per cent.[66] Perhaps the most influential single reason for this change in investment practice is the growing cost of pension plans. If trustees can raise the rate of return on plan investments, the employer may provide existing pension benefits with smaller contributions. Additional reasons include an extensive confidence in the stability of the stock market and the belief that common stocks and real estate investments act as a curb against loss of principle through inflation.[67]

Although the danger attending high-yield investments is the presumably greater risk of losses, there is no evidence available which indicates that greater losses have resulted.[68] Moreover, even

61. *Ibid.*

62. Under the INT. REV. CODE OF 1954, § 503(c), a plan will lose its exemption if it enters into the following transactions with the employer-grantor or related or controlled interests of the employer-grantor: "(1) lends any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest; (2) pays any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered; (3) makes any part of its services available on a preferential basis; (4) makes any substantial purchase of securities or any other property, for more than adequate consideration in money or money's worth; (5) sells any substantial part of its securities or other property, for less than adequate consideration in money or money's worth; (6) engages in any other transaction which is a substantial diversion of its income or corpus. . . ."

63. See Rev. Rul. 57-163, 1957-1 CUM. BULL. 128, 135. See generally Goodman, *Strict Rules Limit Investment of Qualified Pension and Profit Plans*, 14 J. TAXATION 153, 154 (1961). The cost of the investment must not exceed the fair market value at the time of the purchase, there must be a fair return on the investment, sufficient liquidity must be maintained, and the safeguards that a prudent investor would look to must exist. As a practical matter, however, the Internal Revenue Service does not closely watch investment practices.

64. Wall Street J., Oct. 27, 1964, p. 24, col. 3.

65. P-H, PENSIONS AND PROFIT SHARING ¶ 7506 (1964).

66. HARBRECHT, *op. cit. supra* note 31, at 104; U.S. News & World Report, June 15, 1964, p. 103.

67. Bernstein, *Financial Aspects of Pension Funds—Problems of Investment*, N.Y.U. 10TH ANN. CONF. ON LABOR 255, 261 (1957).

68. It is not improbable that the high yield from other investments may more than offset increased losses if they do exist.

with the trend toward higher yield investments, most funds are invested soundly and wisely; the large majority of common stock holdings are of blue chip securities.[69] Nearly all funds, including those controlled by unions, receive expert investment advice.[70] Against this background of generally responsible and sound investment practices, the Cabinet Committee did not suggest legislation as significant as that proposed in the areas of vesting and funding. The Committee felt that because a reasonable difference of opinion existed as to the proper mode of investment, conformity to a percentage limitation on stock investments should not be required.[71] Thus the Committee recommended only two relatively minor legislative changes. First, in order to qualify for special tax treatment a plan may not invest more than ten per cent of its funds in the stock and obligations of the employing company, regardless of the ability of such an investment to meet a fiduciary test. The second investment proposal is an amendment to the Disclosure Act requiring additional information related to a plan's investment activity.

Probably the strongest argument against investing in the trustor corporation is that it places workers' pension funds in the same company from which they draw their wages, with the consequence that the safety of an employee's current income *and* future security rise and fall with the fortunes of one corporation.[72] Another possibly undesirable prospect resulting from extensive self-dealing investment is that the corporation's present directors may retain perpetual control simply because of the investment of pension funds in the trustor corporation; it is the directors of the company who appoint the trustees, and the trustees will be likely to vote the pension plan's shares for those upon whom their positions as trustees de-

69. Business Week, Jan. 31, 1959, p. 99.

70. Often unions invest more conservatively than corporations. For example, at the beginning of 1963, the Machinists Union held bonds in 26 public utilities from New York to California, 2500 shares of General Motors stock, 1300 of General Electric, 1000 of IBM, 2000 of Eaton Manufacturing, and 2212 of Sears, Roebuck. The Carpenters Union had invested $10.9 million, $9.3 million of which was in U.S. Treasury bonds. U.S. News & World Report, May 27, 1963, p. 98. A possible example of speculative investing may be found in some aspects of the investments of the Teamsters pension fund. The Teamsters have invested in two large Las Vegas gambling hotels and two golf courses. Over one million dollars in loans from the Teamster pension and welfare fund went to a department store that eventually became bankrupt. 108 CONG. REC. 20941, 20942 (daily ed. Sept. 26, 1962). Finally, recently Teamster trustees foreclosed on a one million dollar mortgage on a Detroit hotel and on a residential development near Tampa. Of course, this retrospective view of these foreclosed mortgages may not indicate that at the time when entered into they were not sound investments. In addition, there is no presently available evidence of the over-all yield on Teamster fund investments, and perhaps the high yield on some investments more than cancels any losses incurred.

71. CABINET COMM. REPORT 72.

72. DOUGLAS REPORT 53.

pend—current management.[73] The Committee's proposal is not a blanket prohibition against investment in the trustor corporation, but it does limit such investment to ten per cent of the funds in an effort to assure diversification of investments. However, the prohibition suggested would destroy plans such as that instituted by Sears, Roebuck & Co., which has been extremely beneficial to their employees. Since there is apparently no evidence of a manifest risk to employee security from investment in the trustor corporation, it seems unwise arbitrarily to determine that these plans endanger employee security, especially when viewed in light of the success of some of them. Consequently, without some concrete experience and justification, the ten per cent limit should not be imposed on investments in the trustor corporations.

The Disclosure Act presently lacks adequate reporting of investment activity, but the Committee's suggested amendment to the act would rectify this weakness. On the other hand, although the recommended amendment would require disclosure of self-dealing or highly speculative investments, pressure to change investment practices would still necessarily come only from participants and beneficiaries of the plans. It is doubtful whether such pressure would be forthcoming and, even if it were, whether it would deter administrators from excessive investing in unreliable schemes.[74] However, the data collected may be of great value in indicating whether, as well as what, regulatory measures are necessary.

The Committee did not suggest any legislation which might curtail generally irresponsible investments by trustees, but rather recommended reliance upon the present state fiduciary laws to prevent highly speculative investment. Under state fiduciary laws, however, participating employees must discover the violation and bring suit in their own behalf. If experience under the Disclosure Act before the 1962 amendments is an indication, reliance on plan participants to force compliance with a law is ineffectual.[75] House Bill 12566, proposed in the fall of 1964, would amend the Disclosure Act by restricting fund investment to those investments permitted to be made by corporate or individual fiduciaries in the state in which the principal office of the plan is located. The amendment would give the Secretary of Labor the right to investigate and sue to enjoin violations of these state fiduciary laws. No longer would there be complete reliance on participating employees to force compliance.

The Cabinet Committee felt that this proposed legislation is premature without more extensive examination of the effectiveness of the disclosure approach as a means of assuring standards of

73. *Id.* at 89.

74. See text following note 75 *infra*.

75. See note 13 *supra* and accompanying text.

fiduciary responsibility.[76] However, while there may be a lack of evidence indicating a need for extensive federal regulation of investment practices, experience under the Disclosure Act seems to provide ample indication that those who are violating their fiduciary responsibility will not be deterred by disclosure legislation.[77] As a minimum means of guarding employee retirement security against irresponsible investment practices, one of the federal agencies should be designated to assure employees that plan trustees are fulfilling their fiduciary obligations under existing state laws.

Nevertheless it seems that the Cabinet Committee acted with appropriate restraint in refusing to recommend extensive federal control of pension fund investment practices. Because of the failure of the Disclosure Act to require detailed reporting of plan investments, evidence of any threat to the security of these funds is not available. The Committee wisely suggested an amendment to the Disclosure Act which would provide law makers with the requisite evidence of irresponsible investment and attendant dangers to fund security.

III. Conclusion

The degree of federal regulation of pension plans suggested by the Cabinet Committee has surprised, if not shocked, many leaders of both management and labor. Perhaps the most immediate effect of the Report will be significant repercussions at the bargaining table. Both sides surely have had impressed upon them the fact that the possibility of federal regulation is existent. Management may be more willing to grant vesting rights and to assure the unions of more complete funding. Labor, on the other hand, may consider the proposals to be minimum standards and refuse to stop at this minimum point.

Federal regulation seems imminent; the only question is one of degree. Initially it is difficult to determine whether the Report will or should become the legislative guideline. The Report does evidence, however, a willingness and actual desire of important government leaders extensively to restrict managerial discretion in the interest of increased employee security. The concept of private pension plans as federally subsidized supplements to Social Security perhaps forebodes even more extensive regulation than has been suggested. Hopefully, restraint will prevail, and before legislation is enacted clearer and more extensive evidence will be compiled showing the need for specific legislation.

Thomas B. Ridgley

76. Cabinet Comm. Report 79.
77. *Cf.* note 13 *supra* and accompanying text.