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CORPORATE RETIREMENT SECURITY

Edited by ROBERT W. KOLB

Corporate Retirement Security

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Corporate Retirement Security

Social and Ethical Issues

Edited by
Robert W. Kolb

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Preface

In the spring of 2005 a group of scholars gathered in Boulder, Colorado to address the topic of corporate retirement security – one aspect of the entire system of providing retirement income in the United States. By focusing on retirement funds provided under the aegis of private employers, we hoped to make a meaningful contribution to the continuing public policy debate concerning the broader question of how workers (and non-workers and unpaid workers) in the United States are to secure sufficient funds to make possible a retirement income that is in some essential way consistent with their expectations and their lifetime of achievements.

Contributors came from many backgrounds, including business scholars and business ethicists, philosophers, attorneys, and business people who provide services to corporations struggling with the problems of managing their retirement programs in an era of rapid change. These diverse perspectives, drawn from representatives of many disciplines and walks of life, led to a wide-ranging exchange of ideas and the opportunity to learn from those who have a different outlook. The contributions to this volume reflect our society's widespread disagreement on the most fundamental aspects of the employment relationship in general, as well as the proper design of corporate retirement programs and the allocation of responsibility for retirement among individuals, their employers, and other entities, such as the federal government.

The symposium was directed by the Center for Business and Society at the Leeds School of Business at the University of Colorado under the leadership of Deans Steven Manaster and Stephen Lawrence. Major funding to support the symposium was drawn from the Leeds School, the Boulder County Business Report, and through the generosity of George and Judy Writer and their family. Vincent Snowbarger, Deputy Executive Director for Legislative Affairs of the Pension Benefit Guaranty Corporation, attended the entire conference and made a public address to an audience of scholars, students, and members of the Boulder community.

Robert W. Kolb
Boulder, Colorado, USA

List of Contributors

Barry Bennett
Bonneville Power Administration, Portland, OR, USA

Robbin Derry
Northwestern University, Ivanston, IL, USA

Jon Entine
Miami University, Oxford, OH, USA

Sarah Fuhrmann
v-Fluence Interactive Public Relations, San Diego, CA, USA

Joanne H. Gavin
Marist College, School of Management, Poughkeepsie, NY, USA

Eugene Heath
State University of New York at New Paltz, New Paltz, NY, USA

Michael E. Johnson-Cramer
Bucknell University, Lewisburg, PA 17837, USA

Peter D. Kinder
KLD Research & Analytics, Inc.

Robert W. Kolb
Mountain Ridge Place, Boulder, CO, USA

Robert A. Phillips
University of Richmond, School of Business Administration, San Diego, CA, USA

Ken Sloan
Marist College, School of Management, Poughkeepsie, NY, USA

Jeffery Smith
University of Redlands School of Business, Redlands, CA, USA

Patricia H. Werhane
DePaul University, Chicago, IL; University of Virginia, Charlottesville, VA, USA

Duane Windsor
Rice University, Houston, TX, USA

Introduction

Robert W. Kolb

In the United States, individuals draw funds for their retirement from many sources beyond savings made at their own initiative, including entitlements from the federal government, transfer payments from a variety of sources, and funds from their employers, whether public or private. As with so many institutions, these various providers of retirement funds reflect a long history during which the sources of retirement savings have evolved. In the 19th century, very few individuals could rely on government payments or employer-provided pensions. Instead, funds for retirement came from the savings of individuals, or in more cases, from support by younger family members.

Starting in the latter part of the 19th century and continuing to evolve well into the 20th century, more and more employers sought to attract and retain employees by making promises, sometimes quite generous promises, of lifelong pension payments upon retirement. Much of this implicit, or even explicit, contract was predicated upon the assumption that an employee would complete a full career with a single employer, and that the employer was sufficiently stable and financially viable to make a credible long-term promise of those pension payments. The first half of the 20th century witnessed the development of various government programs and entitlements that attempted to provide a floor of retirement income for all citizens. In the last third of the 20th century, and continuing into the 21st century, the nature of work in U.S. society has continued to change in ways that vitiate previous implicit employment contracts and prior understandings regarding retirement arrangements and pension payments. Today's young employee can anticipate numerous changes in employers, or even careers, over a lifetime of work. Further, the "creative destruction" of capitalism seems to accelerate, with firms arising, flourishing, and passing out of existence with a rapidity that was not contemplated at the mid-20th century. All of these changes have caused, and promise to continue to cause, vast changes in both the structure and levels of retirement income for America's workers.

Corporate Retirement Security in the United States

The concept of corporate retirement security refers most directly to employer-sponsored pensions and other retirement income of workers retiring from careers in private sector U.S. businesses. These employer-sponsored plans come in two basic types: defined-benefit and defined-contribution plans.

In a *defined-benefit* plan, the employer promises a series of payments and other benefits to the employee that commence upon retirement and continue throughout the employee's life, and sometimes through the life of the employee's spouse. Thus, these promises represent a continuing obligation that the employer undertakes. These plans are often structured in a way that become richer for the long-term employee, thereby creating incentives for lengthy service and sometimes being structured in a way that bind otherwise restless employees to a single employer. In a *defined-contribution* plan, the employer promises to make a series of payments into an employee-owned account, usually with the payments being made each pay period. Often employers require that employees also contribute to the defined-contribution account, or at least encourage employee contributions by promising to match the employee's contribution. In a defined-contribution plan, the employer completes its obligations when it makes the series of payments into the account, and the value of the account upon retirement, whatever amount it turns out to be, provides the resources from which the retired employee draws to sustain his/her income. No matter whether an employee has a defined-benefit or a defined-contribution plan, portions of any employee's retirement income would come from sources outside the employer-sponsored plan, such as voluntary personal savings, home ownership, and social security income.

Private defined-benefit plans originated in 1875 in the railroad industry, and grew to first prominence in that industry. In the early 20th century, other employers initiated pension plans, and they quickly became a fairly normal part of an employment contract among large U.S. employers.[1] After this period and extending through the heyday of managerial capitalism in the 1950s and 1960s, large and stable major corporations promised their workers retirement security in the form of defined-benefit pensions – an implicit to explicit lifetime guarantee of a level of retirement support that the firm would provide. Typically, much of this retirement income was promised as a series of cash payments based on a worker's longevity and salary history with the company. However, some of the retirement guarantees were also expressed in real terms as consumption opportunities, most notably for health care. For the portion of the retirement income that was expressed in real terms, the corporate provider bore inflation risk.

Part of the implicit idea – and so much was implicit – embraced the idea of a lifetime of loyal employee service to a single company, with a retirement

[1] See Stephen P. McCourt, "Defined Benefit and Defined Contribution Plans: A History, Market Overview and Comparative Analysis," *Benefits & Compensation Digest*, Vol. 43, No. 2, February 2006, published by International Foundation of Employee Benefit Plans. McCourt draws substantially on Stephen A. Sass, *The Promise of Private Pensions: The First Hundred Years*, Cambridge, MA: Harvard University Press, 1997.

reward of loyal support from that lifetime employer that would continue through the employee's life. These retirement plans were often structured in a way that rewarded lengthy periods of service with payment weighting arrangements that encouraged a lifetime career with a single employer. "Job hoppers" would certainly wind up with lower retirement incomes than those employees faithful to a single employer. Of course, the credibility of such retirement promises presupposed stable employers that would maintain their financial viability through the employee's lifetime.

The last 40 years of the 20th century witnessed a vast restructuring of U.S. industry and radical changes in the employment patterns of individual workers. For retirement security, the end result was that it no longer made sense for an individual employee to expect to have a lifetime career with a single employer, and most employers could not make reliable promises stretching the 50, 60, or conceivably even 70, years into the future that would cover a new employee's expected work life and retirement.

In accordance with these new workplace realities, a new form of retirement arrangement has grown to prominence in the last 30 years – the defined-contribution plan. In a typical defined-contribution plan, the employer and often the employee as well, contribute to a separate account in the name of each employee that is held by a third-party fiduciary, often a large mutual fund company. As such, the funds are outside the direct control of both the employer and employee. In establishing the plan, the employer often restricts the range of vehicles in which the funds can be invested. For example, most retirement plans would prohibit employees from investing in antique automobiles or sports memorabilia. However plans are also typically structured so that the employee can make investment decisions within a fairly large range of choices. For example employees can frequently choose between equity investment funds of varying risk levels, or they might invest retirement monies in mutual funds that invest in debt vehicles. These arrangements are also tax-privileged, so the federal government also imposes certain restrictions on how the funds can be used. For example, law restricts employee access to funds before retirement, and even when it allows access under certain circumstances, the law typically imposes penalties for accessing the funds prior to reaching retirement age.

The swing from defined-benefit plans to defined-contribution plans over recent U.S. history has been massive, both in number of plans and in the amount of investment in the differing types of plans. Between 1975 and 1999, the number of private defined-benefit plans fell by 50%, while the number of private defined-contribution plans tripled. Whereas the total amount of assets in defined-benefit plans was twice as large as funds in defined-contribution plans in 1985, funds in defined-contribution plans exceed those in defined-benefit plans today. These trends will probably continue as corporations

actively phase out their defined-benefit plans and as workers covered by pre-existing defined-benefit plans die and those plans are terminated.

All of these changes in retirement security arrangements raise substantial social and ethical questions and reflect a basic change in the relationship between employer and employee. To many, the defined-benefit pattern of providing retirement income reeks of corporate paternalism in which the company said to the employee "Give us your work life and we will take care of you until you die. Trust us to fund the company's pension plan and manage those assets wisely so that you will have a secure retirement income." Under defined-contribution retirement arrangements, the employee must be more independent and must assume responsibility for investing retirement funds wisely, and many workers are poorly equipped to make such financial decisions. In establishing such a plan, the employer essentially says "You work here from one pay period to the next. For each pay period you are here, we will contribute to a retirement fund for you a certain fraction of the pay you earn and we may require you to also make a certain contribution too. We will put those funds in an account under your name, and once we do, we can't touch it. You will have to manage it within the framework we have established, and that may turn out well or badly, depending on what happens in the economy and the investment decisions you make. At any rate, we are done with our retirement obligation to you after every payday. Whatever the value of your retirement funds turns out to be, large or small, that is what you have to work with to support your retirement income."

As these imaginary and perhaps too frank quotations reveal, the shift from defined-benefit to defined-contribution involves a massive shift of risk in several dimensions. I will mention only two. First, there is the question of longevity risk, which is especially important in an environment of improving long-term health care and lengthening lifespans. Under a defined-benefit plan the employer bears the financial risk of making payments for much longer than anticipated for long-lived retirees. By contrast, an employee with a defined-contribution retirement account has an account with a certain financial value at retirement, and the employee bears the risk of outliving her retirement income. Second, the shift from defined-benefit to defined-contribution arrangements also reduces some dimension of employee risk, notably the risk that an employer will default on the pension promise. Retirement funds in defined-contribution plans are quite safe from employer failure, because they are held by a third-party fiduciary. (While the Pension Benefit Guaranty Corporation (PBGC) ensures defined-benefit plans, the coverage is almost always less than complete, and the solvency of the PBGC itself is far from secure.)

The scope of the social and ethical issues raised by retirement arrangements in any society extends far beyond those very central issues involved in the defined-benefit versus defined-contribution choice. The remainder of this

brief essay touches on some of those issues, many of which are covered in more depth by the chapters in this volume.

The very idea of a pension or retirement plan of any sort is a fundamental aspect of any employment contract and goes a long way to defining the relationship between employer and employee, as the imaginary quotations above reflect. By the nature and reliability of its promise, a retirement arrangement between employer and employee can convey great respect and caring for employees. Also, defined-benefit plans can be structured to encourage and reward lengthy service, with the result that some employees may feel trapped in a low-wage job because of the hope of capturing the rich benefits of a generous retirement promise. Both defined-benefit and defined-contribution plans involved different stances toward paternalism, with the defined-benefit plan usually having more paternalistic implications. However, as employers restrict the range of investment vehicles in defined-contribution plans and can impose restrictions on withdrawals even in retirement, they too have paternalistic features. (In defined-contribution plans, the employer can require that a retired employee take the employer-contributed funds in the form of an annuity, rather than at the discretion of the employee's preferences.)

In a defined-benefit plan the employer chooses the investment, or at least chooses an investment manager who chooses the investment plan. For instance, as several of the chapters in this monograph discuss, some defined-benefit plans are now investing in a so-called "socially responsible" manner. This can imply the sacrifice of returns that would accrue to retirees in the pursuit of some social values of the fund managers, values that the pension beneficiaries may not share. This raises the possibility that funds in defined-benefit plans may be invested in a way that does not accord with an employee's values or desires. For example, an employee may have his funds invested in firms that manufacture firearms, alcohol, tobacco, and these policies can be abhorrent to the wishes of particular employees. Similarly, some pension funds may be withheld from pharmaceutical firms that manufacture contraceptives, and such a policy is sure to annoy some fund beneficiaries, just as the decision to invest in such a firm would irritate other beneficiaries covered by the plan.

It is surely the case that many workers are not sufficiently knowledgeable to make wise investment choices. This raises the question of whether the employer that sponsors a defined-contribution plan might have an obligation to provide informational and education to its employees regarding suitable investment plans. On the other hand, such intrusion may erode the individual responsibility of employees for making their own decisions. The very act of establishing a plan that restricts the range of permitted investments restricts individual freedom and substitutes the judgment of the employer for that of the employee.

Often employers resist extending retirement coverage to temporary workers or to classes of permanent workers, preferring to hire "consultants" rather

than employees to save on various costs, including retirement contributions. Some social critics see such practices as illegitimately creating various "castes" of employees and as not being responsible for the long-term welfare of the firm's employees. By contrast, restricting such practices might reduce overall employment with a diminishment of social welfare. Further, many believe that such employment arrangements are and should remain within the discretion of willing employers and employees.

Faced with demands for profitability, many employers are tempted to skimp on contributing to their defined-benefit plans. The necessary contributions for a defined-benefit plan to be "fully funded" depend on actuarial assumptions about the retirement dates and life expectancies of plan beneficiaries. Also, the needed contribution to a plan depends on assumptions made about the investment returns over many decades. By "optimistically" assuming limited life spans for its retirees or by insisting on unrealistically optimistic views on future investment returns, the required funding level today can be reduced. The potential inadequacy of such assumptions may become fully apparent only decades from the present when employees retire and fund assets prove deficient. This situation becomes particularly painful when the firm is no longer able to make up the shortfall or when the company no longer exists. (In an extremely simplified form, this is the story of the pension problems in the U.S. steel and airline industries.) Obviously, this kind of funding decision is not merely a technocratic actuarial problem, but falls squarely in the realm of an ethical decision on the part of the employer. Also, from a social point of view, allowing weak pension funding threatens to move the obligation for covering employee retirement income from firms to the public at large. In such a situation, a questionable ethical decision by an employer on funding becomes a significant social issue for a society concerned with providing a decent retirement income to those who work a full career.

In conclusion, the chapters in this volume touch on virtually all of the issues raised in the Introduction, and they do so from a variety of perspectives. I believe that the ethical and social issues involved in corporate retirement security lie at the core of the employer–employee relationship, that they are central to the social organization of work, and that they will persist in public debate and consciousness for a long time to come. It is my hope that this book contributes to the debate and to a deeper understanding of the very real issues involved in work and the enjoyment of a comfortable and meaningful retirement.

Robert W. Kolb
Boulder, Colorado

Part I

Ethical Issues in Pension Plan Structure

The chapters in this section take on directly the social and ethical issues in the decision between a defined-benefit (DB) and a defined-contribution (DC) retirement plan. They also extend the conceptual problem far beyond that basic dichotomy in interesting ways.

In "Pension Plan Design: An Examination of Corporate Social Responsibility," Joanne H. Gavin and Ken Sloan examine the structure of both types of plans with a view toward corporate social responsibility. They argue that a transition from a DB to a DC plan is often the socially responsible choice. However, Gavin and Sloan insist that the adoption of DC plan implies employer responsibility in educating its workforce and in trying to mitigate some of the risks for the employee that are inherent in the DC plan structure. On grounds of reducing employee risk, they advocate eliminating the employee's ability to borrow against retirement funds, ensuring that retirement funds are diversified and especially not concentrated in the stock of the employer's firm, and that firms ensure that retirement funds be properly managed, either by professionals or by fully educated employees themselves.

In his contribution, "The Pension that Isn't: The Defined-Contribution Retirement Plan," Barry Bennett argues that DC plans are not really pensions at all. Further, he maintains that the shift from DB pension plans to DC savings plans is part of corporate America's abandonment of the post-World War II social contract under which corporations were left largely unfettered to pursue profits in return for providing job security and generous benefits. As Bennett sees it, in the mid-20th century the U.S. embraced an ethic of collective security, which included the socialization of risk through health insurance, private pensions, the social security system, and secure employment. Bennett sees this social contract as succumbing to a radical individualism in which each employee bears life's risks on his own. Bennett advocates a renewed social contract that recovers the true purpose of the corporation as a servant of society involving an ethic of mutual obligation between firm and society, and between employer and employee.

In "Corporate Retirement Security: A Bankrupt Oxymoron," Patricia Werhane attempts to move beyond the DB/DC dichotomy to a new model of

the employer–employee relationship that vitiates some of the old distinctions. In Werhane's view, retirement plans are not an expression of caring or trust, but rather a form of compensation that is part of the employment contract. In some circumstances, for an employer to alter funding arrangements or to fail to make payments to a plan can be simply a form of theft on the part of the employer. Beyond such unethical acts, Werhane urges a new conceptualization of the employer–employee relationship that is more consistent with current economic realities and that also enhances the dignity of workers. She insists that workers re-conceptualize themselves as professionals who bring valuable skills to the market place. Such a rethinking sidesteps the dependency implicit in the very notion of what it is to be an "employee." In an economy in which more and more workers are contingent and temporary, either through worker choice or necessity, Werhane thinks that a model of worker loyalty to his or her profession should be a person's primary allegiance, rather than looking to a single employer as the locus of such a bond.

In her "Trust, Portability, and Sustenance in Pension Plans," Robbin Derry surveys the contributions of Gavin and Sloan, Bennett, and Werhane. Like Werhane, Derry seeks to move beyond the DB/DC opposition and to consider more fully the meaningfulness of work in a full human life, conditioned by the economic realities of our age. Derry advocates thinking of a retirement security plan that is "portable, transparent, trustworthy, sustainable, and sustaining for the decades ahead, one that addresses the needs of lower and middle income wage earners, as well as one that safeguards the savings of higher income employees." In considering the huge challenges in creating such a system, Derry draws on the model of retirement embraced in Chile. The Chilean plan involves some elements of the radical individualism that Bennett bemoans, but it also encourages the integration of a longer work-life into a person's life plan. For Derry, the problem of work is larger than that of getting to retirement as quickly as possible and having plenty of money to spend in the "golden years." Instead, she considers work in the full context of a human life and argues that a longer work-life enriches human existence and can also solve some of the financial issues of retirement.

1

Pension Plan Design: An Examination of Corporate Social Responsibility

Joanne H. Gavin and Ken Sloan

Introduction

The evolution of the modern corporation as we know it today began during the mid-1800s with the introduction of the American railroad system (Chandler, 1980). This developmental process continued over the next century. By the mid-1900s, corporate growth had been so successful that the 50 largest U.S. corporations owned over half of all manufacturing assets and the 500 largest owned over two-thirds (U.S. Senate Resolution, 1964). During this time period, these organizations were driven by economics with the sole purpose of profit generation. However, during the 1950s and 1960s, a change in society's perception of the responsibility of these large organizations began to take place.

At the same time as the country was moving from a nation of small, privately owned companies to a system of large powerful, efficient corporations, change was taking place in our government as well (Henderson, 1968). The rapid formation of huge urban areas caused great overlap of small local governmental systems. For example, during the early 1960s, the Chicago metropolitan area had approximately 1,060 different local government units that often overlapped and competed with each other for dominance (Committee for Economic Development, 1966). Because of situations such as these, governments were often fat, flabby, and swamped with problems brought about by the growing populations. It was during these times that governments first looked to business to become "socially responsible" and help ineffective governments solve the problems of society.

Corporate Social Responsibility

In the late 1950s and early 1960s local and state governments began asking big, successful businesses to help solve pressing problems ranging from uncollected garbage and unsafe streets to ineffective public schools and air pollution (Henderson, 1968). Businesses were very responsive to these requests. Businesses adopted schools, they helped with privatized police forces, they

helped work out traffic problems, and even offered their top executives as consultants to state-level governments free of charge. In the last half of the 20th century, businesses have continued to play an important role in the welfare of society. However, not everyone in a society that continues to place social responsibility at the feet of corporations agrees about what that responsibility should be.

Some people support Milton Friedman's (1970) position that the only social responsibility business has is to maximize shareholder wealth by engaging in free enterprise without deception or fraud. Others believe that social responsibility includes being responsive to the needs of a list of stakeholders including but not limited to: customers, employees, suppliers, governments, communities, the environment, activist groups, and shareholders (Clarkson, 1995). Many people fall somewhere in between the complete lack of responsibility to anything or anyone other than profit generation and total responsibility to anyone who may have even a remote interest in the organization. They believe that corporations should be responsible to their stakeholders but within the limits of what is economically feasible in its continuance.

Stakeholders

Organizations have two groups of stakeholders, primary and secondary. Primary stakeholders are individuals or groups without whose continued participation the corporation cannot survive as a going concern (Clarkson, 1995). "Primary stakeholders groups typically are comprised of shareholders and investors, employees, customers, and suppliers, together with what is defined as the public stakeholder: the governments and communities that provide infrastructures and markets, whose laws and regulations must be obeyed, and to whom taxes and other obligations may be due" (p. 105). All organizations have secondary stakeholders as well. These include the media and other special interest groups. However, secondary stakeholders do not have the same impact on the organization and are not critical for its survival.

Much has been written about the obligations a company has toward its stakeholders. As stated earlier, Milton Friedman believed the only stakeholder a company need be concerned with was its stockholders. Others believe that if you take care of the other stakeholders, especially the primary stakeholders, the stockholders' wealth would be maximized. General Robert Wood, former president and chairman of the board of Sears, believed that if the appropriate needs and interests of customers, employees, and the community were satisfied, the by-product would be satisfied stockholders (Preston, 1990). We agree with this focus on primary stakeholder groups but narrow our focus further to focus on the responsibility a company has to its employees.

Employees

Corporations have a wide range of responsibilities to their employees. Among the most traditional responsibilities companies have to their employees are a just workplace, a fair wage, and a safe environment. In recent times, our changing business environment has also required companies to be called upon to examine their responsibilities to employees in terms of fair treatment during plant closings and employee layoffs.

One concern that has received limited attention is a company's responsibility to effectively and ethically design and manage their employees' pension program. For many, the obligation of a company to responsibly provide for their employees' retirement was a given. In recent times, stories of Enron and other companies lack of fiscal responsibility has brought this issue to the surface. But the issue goes deeper than some "bad apples." The crisis currently being faced by the airline industry highlights a deeper structural concern related to the ability of corporations to responsibly provide their employees' retirement income.

Employer Retirement Programs

The retirement income model in the U.S. has been described as a three-legged stool consisting of social security, an employer pension, and private savings, and, expanding the coverage of employer pension plans has long been a goal of Federal pension policy (Turner et al., 2003). Following World War II, the U.S. experienced a rapid growth in private sector pension plans reaching coverage rates of approximately 50% in the 1970s and stabilizing at that level (EBSA, 2004). While pension plans can present a wide array of terms and provisions in specific plans, they can generally be classified as either a DB or a DC plan.

Over the past 30 years the private pension structure in the U.S. has been undergoing a significant structural shift away from DB pension plans toward DC pension plans as shown in Figure 1.1. In 1979, 63% of workers covered by a private pension plan were in a DB pension plan while 37% were covered by a DC plan. By 1998 that had reversed to 69% of covered workers being in a DC plan and only 31% in a DB plan. In 1974, 43.7% of the private non-farm workforce was an active participant in a private DB pension plan. By 2003, that percentage had dropped to between 17% and 22%. In 1986 the number of DB pension plans totaled 172,643. That number has been in steady decline and, in 1998, the number of DB pension plans stood at 56,405. In 1998, over 92% of all private pension plans were DC plans (EBRI, 2003; McDonnell, 2003).

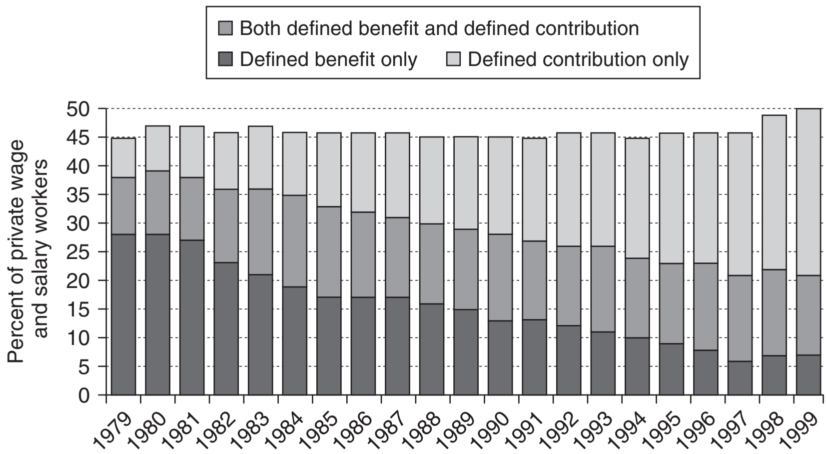

Figure 1.1 DB/DC Participation Rates.
Source: U.S. Department of Labor, Employee Benefit Security Administration, Abstract 1999, Form 5500

DB Plans

A DB plan provides benefits based on a formula that typically multiplies years of service, final average pay, a pension rate (e.g., 1.5% for year of service), and frequently a partial offset for primary social security benefits the participant receive. Under a DB pension plan, the pension benefit received by the participant was defined by the plan's formula and usually was structured to provide an annual pension payment over the life of the worker with a reduced payment made to the spouse for the duration of his/her life. The employee was able to approximate the pension they would receive by multiplying how many years of service they expected to have at retirement and by estimating what their final pay would be. The DB plan formula represented a promise. "We (the company) will pay you a pension of $x dependent upon how long you work for us and what you are being paid just before your retirement." The employee did not have to be concerned with any investment risk and as long as they remained employed by the company, they perceived their pension was secure and backed by the assets of the pension trust established to meet those future promises. DB plan designs are effective at insuring that the funds in the plans are only accessible for the intended purpose of income during retirement.

The primary downside of a DB pension plan, from the perspective of most employees, was the lack of portability. While legislation established vesting and accrual requirements that protect the pension benefit earned by the employee, the structure of the promise is such that if an employee's career consisted of

periods at more than one employer (even if each employer had an identical DB plan), the cumulative pension benefit would be less than the benefit earned if the entire career was at one company. This relates to the benefit being tied to final average pay. If I leave my employer after 20 years, the pension rate and years of service are multiplied against my final average pay as I leave the company. That becomes the pension benefit I am eligible for when I reach retirement age in the future. For that segment of my retirement income, the pension will be based upon a pay rate that is frozen, often for decades. If I work my entire career at one employer, then all years of service are applied to the higher final average pay I am receiving as I am retiring.

In a DB pension plan, the employer, or plan sponsor, is expected to make contributions to a trust in order to fund the pension liabilities being incurred by the plan. In addition to being affected by the demographics of plan participants, the amount of the employer contribution is determined in large part based upon the investment results of the trust. During years in which plan assets earn a higher return, employer contributions would be lower, and, during years in which plan assets earned a lower return, employer contributions would be higher. In a DB plan, it is the employer that bears the investment risk. This presents DB plan sponsors with a degree of funding volatility for obligations incurred under the plan which span a very long period of time.

In the 1970s, DB pension plans were the "linchpin" of the private retirement plan system (Kimball & Morgan, 2002). DB pension plans were historically favored by both large employers and unions (Allen, 1996). "DB plans were corporate America's clear retirement vehicle of choice from the establishment of the first private sector retirement plans in 1875 through the early days of ERISA" (Morse, 2002, p. 1), and, the declining number of DB pension plans has been viewed by labor and retiree advocates as an abdication of employer responsibility (Klein, 2004a). Nowhere is this shift better illustrated than in the fact that no large "New Economy" corporation founded in the 1990s has a traditional DB pension plan (Kuttner, 2001).

DC Plans

DC plans are most commonly 401(k) type plans with over 80% being profit sharing and thrift savings plans. Initially, DC plans were offered as supplements to, or in conjunction with, DB plans (McDonnell, 2003). Increasingly, DC plans are being offered as the sole pension plan by organizations. DC plans addressed a key issue important to participants, the lack of portability in DB plans. However, DC plans made retirement income heavily dependent upon investment decisions made by the individual plan participant, and, shifted that investment risk from the employer and plan sponsor to the individuals' participating in the plan.

In a DC plan, the employer eliminates both the long-term obligation and the funding volatility faced in DB pension plans, instead promising to contribute a specific amount each year pegged to variables like participant pay or firm profitability. In a typical DC plan, the employer may promise to contribute x% each year into an account established in the plan for the participant. DC plan designs eliminate the portability problem inherent in the DB plan design. Whatever I earn at one company remains invested and growing, so the pension funds ultimately available to me upon retirement would be theoretically the same whether it was all earned through one employer, or represented funds accumulated from several DC plans. In a DC plan, the issue from the participants' perspective is not portability but investment risk.

Reducing funding volatility was a major driver behind employer's shift from DB to DC pension plans (Klein, 2004b). In a DC plan, the employer's obligation is satisfied once they make the promised annual contribution. It is the employee who will benefit if the return on the assets in his/her account is higher than planned, and, it is the employee who will be hurt if the return on assets in his/her account is less than planned, or if the plan experiences an investment loss. This risk is especially acute as the employee nears retirement since even small percentage losses translate to relatively large dollar losses, and the employee will have less time to make up for losses or underperformance in the years remaining before retirement.

Another criticism of DC plans is that pension funds can be accessed or diverted from the intended purpose. In a DB plan, the assets invested in the pension trust to cover the participants' future pension obligation are not available to them except for the promised purpose of providing income in retirement. However, in most DC plans, the employee has access to the funds and can use those funds for purposes other than retirement income. When I terminate my employment with an employer, my DC plan account balance can be withdrawn and rolled over into my new employer's DC plan or into an IRA. However, I can also take those funds and use them for any purpose, incurring in that year both an income tax liability and an early withdrawal penalty. Even if I remain with my employer, I can often withdraw money for specific purposes like medical expenses, educational expenses, or purchasing a home. Many plans also provide loan features that allow participants to borrow against their accounts thus reducing the balance invested and accumulating earnings.

What is the Responsibility of the Employer?

Irrespective of the form of the pension program offered by employers, there is an implied covenant that the program will provide some degree of reliable and adequate income in retirement, and some view the decline of the DB pension

plan as meaning fewer individuals will have that (Kimball & Morgan, 2002). Those that view the DB plan as the best vehicle to deliver on this promise look to Congress to act in order to reverse the trend. Among the actions they call for are: reducing the overregulation of DB plans (Morse, 2002), repealing the cap on compensation which can be used to calculate a DB plan benefit, privatizing the Pension Benefit Guarantee Corporation (PBGC) and shifting it from a requirement of plan sponsors and employers to a voluntary election made (and paid) by individual plan participants, and, easing the ability of employers to recover surplus assets in DB plans (Kimball & Morgan, 2002). While there is no doubt that some actions by Congress could increase the relative attractiveness of DB pension plans, the question should not be how do we make DB plans more attractive for employers, but, will moving back in the direction of DB plans provide for a greater degree of adequate and reliable retirement income? That is the claim of some and is reflected by a leading benefit consultant stating that the addition of a DB plan would "help satisfy employees' desire to have a secure retirement source" (Kaplan, 2003, p. 90).

But do DB plans provide a greater degree of reliability of future retirement income? Simply looking at the research that examines participants in DB versus DC plans today is not sufficient to answer the question of whether, at a structural level, DB plans provide a more reliable and a more secure source of retirement income than DC plans because that research includes the effects of plans as they operate today. It was noted earlier that particular provisions of DC plans divert funds from the intended purpose of the plans, and, just as Congress could act to increase the desirability of DB plans, they could also act to address current plan provisions in DC plans that work against the primary purpose of a retirement program.

It is suggested that those that are critical of the move from DB to DC plans or that call for measures to spark a return to DB plan designs do so from a romanticized view of the past described by James Klein, President of the American Benefits Council as, "a misty view of a system where every worker got a gold watch and a guaranteed, generous monthly check when he or she retired" (Anonymous, 2004a, p. 6). But such an idealized view never existed, at least not for large numbers of workers. According to Dallas Salisbury, President, Employee Benefits Research Institute, such pension coverage "never applied to more than one-third" of all employees before the shift from DB to DC plans began (Salisbury, 2004, p. 6).

The Insecurity Inherent in DB Pension Plans

The concept behind a DB pension plan is straightforward. An employer estimates the age at which a plan participant will retire, the amount of the annuity

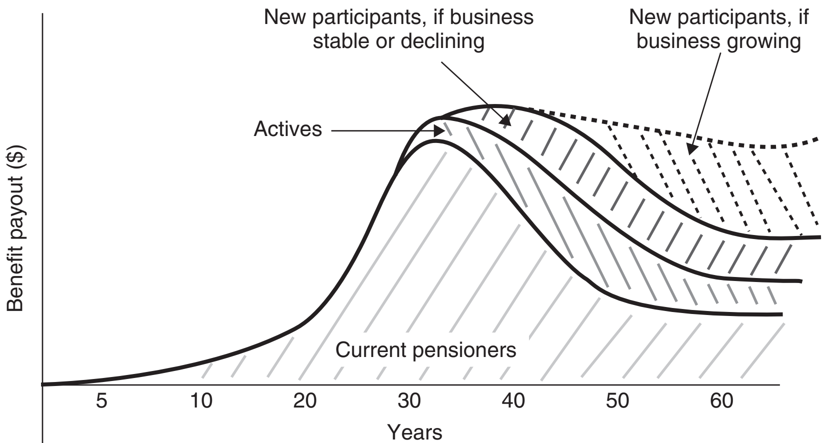

Figure 1.2 Illustration of Pension Fund for a Young Company.
Source: Berner, R., & Harris, T. *Pension missiles: Is the Cure Worse than the Disease?* New York: © 2004 Morgan Stanley

they will receive at that time, and how long they will receive those payments based upon life expectancy. From that, enough money must be set aside to fund those payments based upon estimated earnings from the assets invested.

The employer bears the risk associated with underperformance of investments. The employer also bears the risk of not having sufficient funds set aside if they underestimate life expectancy. This is becoming an increasingly large risk as we see medical and technological advances increase life expectancy in ways that are at best difficult to forecast. Those are the traditional risks of which plan sponsors are generally quite cognizant. They are risks inherent in any forecast or plan.

An inherent structural issue with a DB plan design and a potentially more serious risk is associated with the maturation of the company sponsoring the DB pension plan. A DB pension plan carries with it a promise that is multigenerational in nature. An employee hired out of college may work for four decades before retiring and then draw pension benefits for two or more decades after leaving the company's employment. In a young company, the majority of payments from the plan are 30–50 years off. There is sufficient time to invest and any shortfalls from expected returns on invested assets have time to be recouped. This is illustrated in Figure 1.2.

As the company matures, the plan faces an increasing number of pensioners in relation to active participants as illustrated in Figure 1.3. It also means that a higher proportion of the funds assets will be needed to meet promised payments being made each year. Just as an individual in a DC plan faces greater investment risk as they approach retirement because the impact of shortfalls will be larger and there will be less time to recoup them, sponsors of DB plans

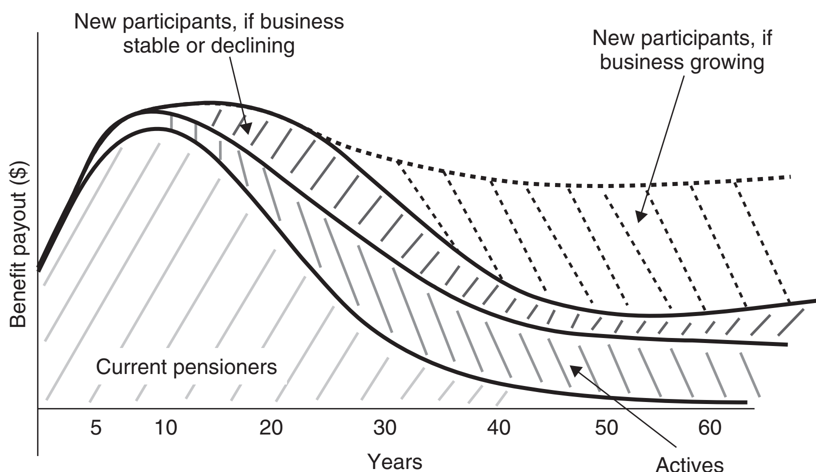

Figure 1.3 Illustration of Pension Fund for a Mature Company.
Source: Berner, R., & Harris, T. *Pension missiles: Is the Cure Worse than the Disease?* New York: © 2004 Morgan Stanley

face similar risks. While the risk increases for a mature company's DB plan, prudent management of that risk to insure that cash inflows from investment returns on the plans assets and cash outflows to retirees are matched, the plan can continue to operate without difficulty. This translates to a need for a much more conservative investment strategy than is in place today in DB plans (Berner & Harris, 2004). It also requires that there be an ongoing new flow of contributions to offset any shortfall from invested assets.

This is a critical point. A DB plan by design becomes increasingly risky as it matures, and, unless a plan remains in place and active, as more of the participants begin drawing out pensions, there is an increasing likelihood that the trust will be unable to deliver the promised benefits even if it is fully funded at the time it is terminated. Even for active plans, the ability of the plan to meet its promises is impacted by the mix of new and active participants to retirees. The higher the proportion of retirees to active participants, the greater the risk presented to the plan. Thus, there is a structural mismatch between the dynamic relationships that make a DB plan viable and the underlying demographics of the workforce (i.e. an aging population and an increasing number of retirees to individuals active in the workforce). The structural issues related to DB plans, demographic trends, and investment principles have led Berner and Harris to state that "without changes, we believe that the US defined benefit pension system as a whole is unlikely to be able to keep the promises made" (2004, p. 7).

These structural issues are exacerbated when you put them into the context of economic conditions. Fortune magazine reported that in its September, 2004 bankruptcy filing, U.S. Airways said that it would be "irrational" to keep

making contributions to its under-funded pension plans, since it "provides no benefit" to helping the company stay alive (Revell, 2004, p. 38). While this may be one of the more dramatic examples, it illustrates an important point. Pension assets are invested and the majority of those assets are in equities. When the economy weakens and stock values fall, the value of the assets held in pension plans falls often creating an under-funding. In 2002, two-thirds of the 360 Standard and Poor 500 companies that offered a DB plan indicated that they were under-funded (O'Meara, 2002). Under the DB model, the employer should increase contributions to make up for that shortfall. However, if the reason underlying the weak stock values is related to weaknesses in the economy, then the company sponsoring the plan is also likely to be facing some business pressures. The greater the under-funding and the greater the business pressures, the greater the likelihood that the company will either elect to terminate the plan or be forced to terminate it through the actions of creditors.

In a testimony before the U.S. Senate, Bradley Belt, Executive Director of the PBGC, cited figures that would indicate that 75% of all DB plans have been terminated over the past two decades (Testimony of Bradley Belt, 2004) and 30% of plan sponsors are considering freezing existing plans (Belt, 2004). A frozen plan impacts a participant in much the same way as our earlier illustration of an employee in a DB plan that terminates employment with an accrued benefit and moves to another company. While the benefit they earned as a plan participant remains, the value of that benefit is "frozen" and hence would not reach the levels that the employee had anticipated. Additionally, data suggests that "freezing" a plan is often a precursor to terminating a plan (Testimony of Bradley Belt, 2004).

While the PBGC exists to insure the benefit of terminated plans, it is operating at a substantial deficit and faces a serious looming crisis. Bradley Belt, the Executive Director of the PBGC, laid out the magnitude of that crisis:

- The PBGC ran an $11.2 billion deficit in 2003.
- The PBGC has an $85 billion exposure to "junk-bond-rated companies" that are at higher default risks.
- The private DB system had a $400 billion gap between assets and liabilities at year end 2003 (Testimony of Bradley Belt, 2004).

Two recent examples of the magnitude of the problem facing DB plan sponsors, from the employers' perspective, are illustrated by the situation faced by Bethlehem Steel and United Airlines. When Bethlehem Steel terminated its pension plan in December, 2002 it was only 45% funded and had $4.3 billion in unfunded benefit liabilities. In July 2004, United Airlines' DB pension plans were only 46% funded and had $8.3 billion in unfunded benefit liabilities. Such

terminations mean participants get only a portion of the benefit promised by the company in the plan, and, that all remaining companies with DB plans bear a portion of that unfunded liability through increased PBGC insurance premiums. This expense would then be borne by taxpayers if the PBGC insurance fund proves inadequate.

An employer offering a DB pension plan has a responsibility to employees that the plan will be there when they retire and will be able to meet the payments promised. Yet 75% of DB plans were not there to provide the promised benefits. Economic necessity (or expediency) resulted in their termination. Those terminations meant reduced benefits to participants. When three-quarters of plans of a given design, namely DB plans, prove not to be viable, it is unreasonable to strive to perpetuate that approach to providing retirement income.

Issues with DC Plans

Structurally, DC plans do not face the issues of under-funding the benefits promised because the promise generally takes the form of a contribution to the employee's account in the year in which the benefit is earned. For employers, this removes the funding volatility and the decades long liability that plagues DB plans. Nor does a termination of a DC plan carry the same loss for participants since the assets accrued belong to the participants and not the trust. Hence, they remain invested and earning a return for the participant. A DC plan also eliminates the negative impact upon pension benefits associated with job changes.

The key issue with a DC plan design is not one of plan reliability but of the adequacy of the retirement income available to participants. In 2004, the median balance accumulated in DC plans was approximately $40,000 which would be enough to produce a pension annuity of $116 per month. If we limit that to only long-tenured and continuously participating employees in DC plans, the accumulated balance averages approximately $175,000, or enough to produce a pension annuity of approximately $510 per month (Salisbury, 2004). One recent study by Freidberg and Webb indicates that DC pension plans have increased the age at which employees retire by 2 years when compared to workers in DB plans (Anonymous, 2004b) and that the "elderly with DC pensions are more likely to outlive their assets, compared with elderly with DB pensions" (Friedberg & Owyang, 2002, p. 32).

These issues are not structural issues in the concept of a DC plan but issues related to design features. DC plans can provide a pension benefit that is as large as or larger than those following a DB plan framework. Issues of adequacy stem from two primary sources. First, the accessibility of money intended to provide retirement income for other purposes and, second, the

quality of the investment decisions made by the participant and the risk associated with those decisions.

DC plans present an appealing source of funds for participants facing financial needs. They have an account which has what they perceive to be a substantial balance and may be decades from retirement. Under that scenario, many individuals tap into their plans to fund other financial needs. Consider an individual who is laid off from his/her employer. They take their DC plan assets and roll them into an Individual Retirement Account (IRA). As unemployment drags on beyond the time covered by their severance payment, they withdraw some money from their IRA. They pay income tax on this withdrawal and also pay a 10% penalty for making a withdrawal before age 59½. In addition, many DC plans allow the participant to take out a loan for any reason. In 2003, 18% of all eligible participants in 401(k) plans had an outstanding loan against their account.

For DC plans to provide adequate retirement income, it is essential that the laws regulating DC plans be changed to restrict access to plan assets for retirement income only. While such a total restriction may not be feasible in plans that allow the employee to make contributions in addition to those made by the employer, such a restriction should certainly be applied to the company contributions and resultant earnings.

The issue of investment decisions and risk poses a more substantial problem when it comes to insuring the adequacy of retirement income from a DC plan. With 64 million active participants in private sector DC plans in 2004 (Salisbury, 2004) and the performance of the stock market since 2001, large numbers of employees near retirement are experiencing first hand the issues of investment risk and fund adequacy. By some estimates, many DC plan participants will need 30 years to make up for the losses incurred in the bear markets of 2000 and 2001 (Erickson, 2003).

While investment risk cannot be eliminated, it can be reduced. First, prudent management of investments requires determining objectives and determining the best way to achieve those goals. Most individuals have no conception of how much money they need to accumulate in order to provide a specific level of income for their retirement years. Most individuals don't know how many years of retirement they should expect (i.e. projected life expectancies). Making matters worse, even if a participant knows that some investments generally provide higher returns along with higher risks, they generally have no way of assessing the degree of risk that is appropriate based on their age and the accumulated assets in relation to retirement income targets. All of this would suggest that more emphasis on education and communication is necessary and should be provided to employees by employers sponsoring DC plans (Kaplan, 2003). While this is appropriate, plan sponsors need to

consider design elements that either allow or require professional management of accounts. Regulations currently allow for such plan directed management; however, legislation would need to address the fiduciary risks associated with that approach, as well as the fiduciary risk which emanates from employee provided education that is currently treated by the regulations as providing financial advice.

One way of reducing the risk that many Enron employees experienced with the collapse of their 401(k) plan is that regulations should be adopted that prohibit concentrating assets in any single investment, most commonly today the employer's company stock. DC plan designs that direct company contributions to company stock should be severely restricted, if not prohibited outright. Further, the percentage of funds in a DC plan which participants can direct to any single source should be limited. It would be advantageous if such regulations also included age-based risk parameters. Such guidelines could provide the framework to shape investments toward lower risk portfolios as an individual participant nears retirement.

Finally, DC plans need to move to a design that enables participants to easily translate their DC plan assets into an annuity income stream. When an individual is in retirement and the assets need to be managed to provide an income stream for 20 plus years, few individuals can prudently manage the risks and investment fluctuation that will occur over that period.

Conclusions

Corporations have a number of responsibilities to their employees. Some are dictated by legislation that stipulates standards of workplace safety and freedom from sexual harassment to note two. Additionally, corporations owe their employees a high level of stewardship and fiscal responsibility when it comes to providing pension benefits. When a company establishes a DB pension program, it is taking on a multi-generational program. It is entering into an exchange with employees, a covenant. If you work for the company we will provide you with a pension of a defined amount based upon your final average pay when you retire. That the law allows that program to be terminated with the obligation incurred limited only up to the accrued benefits to that point, few would find it acceptable if companies entered into such programs expecting to terminate them.

Yet the very structure of a DB pension program, and the obligations it incurs, becomes increasingly difficult to sustain as the company matures and the number of pensioners increases in proportion to active workers. Given the number of plans terminated or frozen over the past two decades, and the

number of under-funded plans today, it is suggested that presenting a DB pension program as a vehicle which will provide secure retirement income to employees is not properly disclosing to participants the degree of risk associated with the pension that they may be planning on when they retire in 10 or 20 years. To do that, to inform employees of the risks inherent in the DB plan, to openly communicate the degree the pension trust is under-funded, or the assumptions used to project future liabilities would have the effect of reducing the perceived value of that employee benefit.

Employees often perceive that a move to a DC pension plan is putting the employee at risk while the employer is insulated. Rather, in a DC plan, there is greater transparency. The employee can see the value of his/her DC retirement account and assess whether it will be adequate or not. The employee can see the fluctuation in that account based upon the performance of invested assets. In a DC plan the employee can more easily see the risks that are hidden from view in DB plans.

In a DB plan, the retirement income of the collective employee and retiree population is at risk based upon the adequacy of the pension trust. In a DB plan, the ability to make up for shortfalls from investment volatility depends upon the financial health and strength of the company decades in the future, and, the interest of the management of the company at that time to continue the plan.

It is suggested that by moving to DC pension plans companies are not abdicating their responsibility to provide for the retirement income of employees but moving to a more fundamentally sound model. This is not to say that there are no problems with DC plans as many are structured and managed today. For a company to offer a DC plan in a responsible manner, that is to provide one that will likely yield adequate retirement income, several changes need to be made. The ability to borrow against retirement funds needs to be eliminated. The ability to invest all, or most of, the assets in a single area like company stock needs to be prohibited. Finally, the ability to elect to have funds managed professionally, or, to provide adequate training and resources to self-manage one's funds is necessary.

Even with these and other actions, there will still be investment risk that is greatest as the individual approaches or is in retirement. To address that issue attention should be given to ways to reduce that risk. Perhaps some form of insurance akin to what the PBGC was established to provide in the DB arena would be possible. This remains a significant issue and it is beyond the scope of this chapter to propose solutions. However, rather than trying to fix the problems associated with DB pension plans which we have shown are structurally flawed, companies should actively embrace actions that would begin to address the security issues that exist under the more structurally sound framework of DC pension programs.

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2

The Pension That Isn't: The Defined-Contribution Retirement Plan

Barry Bennett

According to Webster's, a pension is "a fixed sum paid regularly to a person." For centuries this was its one and indisputable meaning. Over the past 25 years, however, the word has assumed a much different meaning. For most employees it now signifies merely a tax-deferred savings account to which they (and in most cases their employer) make fixed monthly deposits, whose value at retirement will depend on the success of each employee's investments. The traditional pension in which the employer makes a fixed monthly payment in retirement based on salary and years of service has largely given way to the 401(k) plan, also called the *defined-contribution pension*, in which the employer makes fixed payments during the employee's working years but offers no guarantees afterwards. Thus, the risk of financing retirement has been transferred from the employer to the employee.

This chapter will argue that the shift from defined-benefit pension plans to defined-contribution savings plans is part of corporate America's abandonment of the post-World War II social contract under which corporations were left largely unfettered to pursue profits in return for providing job security and generous benefits. During the middle decades of the 20th century the United States embraced an ethic of collective security – the socialization of risk through health insurance, private pensions and social security, and secure employment. This ethic has been gradually yielding to a radical individualism in which each employee bears life's risks on his own.

The chapter will trace the rise and decline of the traditional pension, which has been abandoned at the same time as other benefits have been reduced, union membership has plummeted, and job security has all but disappeared. The demise of the pension is but one consequence of the shift in power from workers to corporations and the abandonment of shared burden and risk. Only a renewal of the ethic of mutual obligation can restore a working social contract to American workers.

A Brief History of Pensions

The Bible records history's earliest known pension. After 37 years of captivity, King Amel-Marduk of Babylon, son of Nebuchadnezzar, freed the conquered King Jehoiachin of Judah, who "lived as a pensioner of the king for the rest of his life. For his maintenance, a regular daily allowance was given to him by the king as long as he lived."[1] The ancient Greeks awarded pensions to disabled paupers.[2] The occupational pension appeared during the Middle Ages. Medieval pensions were often ways to reward those who had provided exemplary service to state or church; or, alternatively, to rid institutions of the old and infirm to make way for the young and strong. Thus, in 1286 Philip de Harwodelme, Rector of Bigby, worn down by age and disease, was awarded a pension of 20 marks (13 pounds) per year. In 1294 the monks of St. Augustine in Canterbury awarded their former abbot, ill and poor, a pension of 10 marks (7 pounds) a year.[3] Well established by 1500, pensions became even more common after the Reformation reduced the number of monasteries, thus dispossessing many monks. In 1539, for example, monks at one religious house were each awarded pensions of 5–6 pounds per year, while the abbot was awarded an annual pension of 80 pounds.[4]

The first state pensions were awarded to military men or senior state functionaries. Charles III of Spain introduced military pensions in 1762, while Napoleon's promise to pay pensions to all veterans was so extravagant that by 1813 pension payments to 100,000 former soldiers constituted 13% of the military budget.[5] In the American Colonies churches granted pensions to clerical widows and orphans, while after the American Revolution the United States offered annuities to generals, war heroes, and those disabled in battle. As these examples demonstrate, Colonial America did not understand the pension as retirement income; instead, the term connoted any periodic payment.[6]

The first formal occupational pension in the United States was established by the American Express Company in 1875. The annual benefit was 50% of annual average pay during the 10 years preceding retirement, to a maximum of $500 per year. Eligibility, however, was quite limited. Pensions were available only to workers who had served the company for 20 years, attained age 60,

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[1] *The New English Bible.* 2 Kings 25.29–30, Oxford, UK: Oxford University Press and Cambridge University Press, 1970.

[2] Lewin, C. G. (2003). *Pensions and Insurance Before 1800* (pp. 6–7). East Lothian, Scotland: Tuckwell.

[3] Lewin (2003, p. 23).

[4] Lewin (2003, pp. 175–177).

[5] Blackburn, R. (2002). *Banking on Death or, Investing in Life: The History and Future of Pensions* (pp. 39–43). London, UK: Verso.

[6] Steven, A. S. (1997). *The Promise of Private Pensions* (p. 6). Cambridge: Harvard University Press.

and were disabled.[7] As the pension system grew the railroads took the lead; by 1905, 35% of railroad employees, almost half a million workers, were covered by pension plans. By 1920 most large enterprises – utilities, banks, mining, steel, and oil companies – had established pensions.[8] Payments were typically between 1% and 2½% of average earnings during the 10 years preceding retirement, multiplied by years of service.[9]

The modern pension system grew out of the union movement. In 1946 the United Mine Workers went on strike to demand an industry-wide pension. President Truman took over the mines and imposed a compromise pension plan on the two sides.[10] In 1948 the pension battle tilted toward employees after the National Labor Relations Board ruled that employers had a legal obligation to negotiate the terms of pension plans.[11] This decision spurred the United Steel Workers of America and the United Automobile Workers to negotiate pensions.[12] Employers in these industries also resisted. To avert a steel industry strike, in July 1949 President Truman established the Steel Industry Board to recommend settlement terms. That September the Board issued its report, concluding that "a social obligation rests upon industry to provide insurance against the economic hazards of modern industrial life, including retirement allowances, in adequate amount as supplementary to the amount of security furnished by government."[13] The Board accepted the common definition of a basic pension as 30% of pre-retirement income.[14]

By the end of 1960 one-half of all private sector workers, 23 million people, were covered by defined-benefit pensions.[15] During the 1960s pensions underwent "radical transformation" as benefit formulas were substantially liberalized and employers introduced vesting and early retirement. By the decade's end more than 75% of workers were in plans with vesting provisions.[16] About 60% of active workers covered by pension plans were in manufacturing; in the

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[7] William, C. G., & Francis, P. K. (1976). *Pension Plans and Public Policy* (pp. 27–28). New York: Columbia University Press.

[8] Greenough & King (1976, p. 30); Seburn, P. W. (1991). Evolution of employer-provided defined benefit pensions. *Monthly Labor Review*, *114*, 18.

[9] Seburn (1991, p. 17).

[10] Blackburn (2002, p. 62).

[11] Inland Steel Co. versus NLRB, 170 F.2d 247 (7th Circuit 1948).

[12] Munnell, A. H. (1982). *The Economics of Private Pensions* (p. 12). Washington, DC: Brookings Institute.

[13] qtd. in Blackburn (2002, p. 62).

[14] Steven, S. (1989). Pension bargains: the heyday of US collectively bargained pension arrangements. In P. Johnson, C. Conrad, & D. Thomson (Eds.), *Workers versus Pensioners: Intergenerational Justice in an Ageing World* (p. 101). Manchester, UK: Manchester University Press.

[15] Seburn (1991, p. 20).

[16] Davis, H. E., & Strasser, A. (1970). Private pension plans 1960–1969 – an overview. *Monthly Labor Review*, *93*, 45.

non-manufacturing sector pensions were concentrated in the construction, transportation, communication, and public utility industries[17] – all heavily unionized.

Retirement security reached its high-water mark with passage of the Employee Retirement Income Security Act of 1974 (ERISA), which established minimum levels of funding and vesting and created the Pension Benefit Guarantee Corporation, which pays pension benefits if an employer terminates a pension plan. With passage of the Social Security Act in 1935 the government had recognized its obligation to ensure a minimum level of old-age security. With passage of ERISA the government declared that private industry shared this obligation. In its report on the bill, the Congress favorably quoted the Steel Industry Board's report that "[w]e think all industry in the absence of adequate government programs, owes an obligation to workers to provide for maintenance of the human body in the form of medical and similar benefits and full depreciation in the form of old age retirement. . . ."[18] As a former member of the President's Council of Economic Advisers has noted, the social security and private pension systems "are alternative vehicles to achieve a targeted level of guaranteed retirement benefits."[19]

In 1974 the word *pension* still connoted a guaranteed payment. But the rise of the private pension system had coincided with two other post-war phenomena. The United States' dominance of the world economy allowed prosperous American corporations to share their wealth with their employees through rising wages and a generous array of benefits, including health care, paid vacations, and pensions. At the same time unionization, which peaked at 35% of the non-farm workforce in 1954 and remained a significant if declining force for the next two decades,[20] forced corporations to accommodate labor's concerns. As corporations adapted to a changing world economy they would leave these phenomena and a shaken pension system in their wake.

The Shift to Defined-Contribution Plans

In 1974 Congress predicted that by placing pensions on sound footing, ERISA regulations would "encourage rather than diminish efforts by management

[17] Davis, & Strasser (1970, p. 47).

[18] United States Congress House. Committee on Education and Labor. Report on the Employee Retirement Income Security Act of 1974. *93rd Congress*, 2nd session H. Rep. 533, reprinted in *United States Code Congressional and Administrative News 93rd Congress* – 2nd Session 1974 (St. Paul: West, 1975) 4641.

[19] Munnell (1982, p. 89).

[20] Gordon, D. M. (1996). *Fat and Mean: The Corporate Squeeze of Working Americans and the Myth of Managerial "Downsizing"* (p. 220). New York: Free Press.

and industry to expand pension plan coverage and to improve benefits for workers."[21] This promise was not to be. Participation in defined-benefit plans peaked at 30.2 million in 1984 and declined to 23 million by 1998. During the same period participation in defined-contribution plans grew from 30.6 million to 50.3 million.[22] In 1979 83% of workers covered by a retirement plan were covered primarily by a defined-benefit plan. By 1996 only 50% were,[23] and by 2003 only 35%.[24] In 2003 only 20% of all workers were in defined-benefit plans while 51% were in defined-contribution plans.[25]

Relatively few employers have replaced defined-benefit plans with defined-contribution plans. Instead, this massive shift occurred because almost all new plans established in the past 25 years have been defined-contribution plans, primarily 401(k) plans.[26] Several factors have been cited to explain this trend: the shift of employment from the unionized manufacturing sector to the non-unionized service sector, where employers prefer defined-contribution plans; increased regulatory requirements for defined-benefit plans; and workers' growing acceptance of defined-contribution plans.[27] Each of these factors contains a germ of truth; as an explanation of the shift they are incomplete and misleading.

As shown above, pension plans blossomed when unions made them a subject of collective bargaining. But union membership, which declined slowly from its peak in 1954 until the 1970s, fell precipitously thereafter.[28] In 2003 a mere 8.2% of the private workforce was unionized.[29] This period of rapid decline coincided with the shift to defined-contribution plans.

Yet even this tiny percentage hides a wide variation in union membership by industry. For example, in 2003 the leisure and hospitality industry had a

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[21] H. Rep., US Code 4647.

[22] Turner, J. Muller, L., & Verma, S. K. (2003). Defining participation in defined contribution pension plans. *Monthly Labor Review*, *126*, 36.

[23] Ippolito, R. A. (1997). *Pension Plans and Employee Performance* (p. 4). Chicago: University of Chicago Press.

[24] U.S. Department of Labor (2004). *National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2003* (p. 3). Washington, DC: GPO.

[25] U.S. Department of Labor, *Compensation* 3. Some workers have both types of plans. Therefore, adding these percentages would overstate the number of workers with a retirement plan.

[26] Ippolito (1997, p. 79); Hinz, R. (2000). Overview of the United States private pension system. In Organisation for Economic Co-operation and Development (Ed.), *Private Pension Systems and Policy Issues* (p. 27). Paris: OECD.

[27] See, for example, Beller, D. J., & Lawrence, H. H. (1992). Trends in private pension plan coverage. In J. A. Turner, & D. J. Beller (Eds.), *Trends in Pensions 1992* (pp. 68–71). U.S. Department of Labor. Washington, DC: GPO.

[28] Gordon (1996, p. 220); Mishel, L., Bernstein, J., & Boushey, H. (2003). *The State of Working America 2002/2003* (pp. 189–190). Ithaca: ILR P-Cornell University Press.

[29] U.S. Department of Labor (2004). *Union Members Summary*, January 21.

unionization rate of 2.8% and food service (a subset of the hospitality industry) only 1.0%. On the other hand, the construction industry had a unionization rate of 16%, manufacturing 13.5%, and transportation and utilities 26.2%.[30] These are the industries that led the pension movement and are where defined-benefit plans are concentrated today. Even in these industries, however, unionization rates are low by historical standards and virtually all new retirement plans have been 401(k) plans. Thus, even accounting for employment shifts the data reveal a marked preference for defined-contribution plans.[31] It is not the shift in employment that accounts for this preference: it is the shift in *power*. Service-sector employers do not merely prefer defined-contribution plans. Without unions to contend with, they have the power to impose defined-contribution plans.

The concentration of defined-benefit plans in unionized industries reflects the power of unions to obtain benefits for their members. In 2001 non-unionized workers were paid an average wage of $16.67, while union members were paid $21.40, for a union premium of 28%.[32] Similarly, 83.5% of union members versus 62% of non-union employees had employer-provided health insurance, and 72% of union members but only 44% of non-union employees had a retirement plan, whether defined-benefit or defined-contribution.[33] In all measures blue-collar workers enjoyed an even greater union advantage,[34] as blue-collar workers have bargaining leverage only if they are unionized.

ERISA and subsequent legislation did increase the regulatory burden of defined-benefit plans. Yet much ERISA regulation applies to defined-contribution plans as well, and the increased costs were significant only for smaller firms. They cannot explain the wholesale shift among all firms toward defined-contribution plans.[35] Moreover, large firms began the shift to defined-contribution plans in the early 1970s, before the new regulations took effect.[36] Although legislation passed in 1987 required full funding of traditional pensions – also sometimes cited as a reason for the shift – the move toward defined-contribution plans was well under way before then.[37]

Finally, in light of the stock market boom of the 1980s and early 1990s and the relentless drumbeat of financial analysts touting the virtues of stocks, undoubtedly there is greater worker acceptance of defined-contribution plans. As

[30] U.S. Department of Labor, *Union Members*, Table 3.
[31] Ippolito (1997, p. 5).
[32] Mishel et al. (2003, p. 191).
[33] Mishel et al. (2003, p. 193).
[34] Ibid., footnote 32, p. 191.
[35] Ippolito (1997, pp. 5, 79–80).
[36] Beller, & Lawrence (1992, p. 65).
[37] Ippolito (1997, pp. 5, 80).

discussed further below, however, it defies all experience and logic to suggest that worker preferences are behind the movement away from traditional pensions. Historically unions have strongly favored defined-benefit plans because of their determinable benefits and the absence of risk.[38] And if "worker acceptance" means simply less resistance, then the analysis begs the question: it does not explain why firms have pressed workers to accept defined-contribution plans.

A much greater benefit than reduced regulatory cost accrues to employers that adopt defined-contribution plans: the shift of investment risk from the firm to its employees. Under a defined-benefit plan the employer takes the risk that its pension funds will be adequate to fulfill its promise of a fixed payment. Under a defined-contribution plan, each employee assumes the risk that his investments will generate an adequate retirement income. This shift in risk undermines the true promise of the pension: that as a society we are more than simply a collection of individuals, and we do not discard the few to benefit the many.

The Corporate Transfer of Risk

The employer's undertaking to make a monthly payment during the employee's working years rather than in retirement does more than shift financial risk to the employee: it works a fundamental change in the character of the risk. Only a small percentage of workers will retire in any year. If the money the firm has set aside has generated insufficient income to pay that year's pensions, the firm can draw on other funds to meet its obligations. Money available for the following year's retirement class – or the one after that – may exceed promised benefits, thus compensating for the shortfall. The risk is shared among workers and spread across generations: it is a collective risk. Under a defined-contribution plan, the risk is painfully individual.

Several studies have claimed that retirement benefits will be greater under defined-contribution plans than under defined-benefit plans.[39] Their findings, however, are based on the median or mean worker.[40] Thus, these studies also mask the demise of the collective. In a defined-benefit plan all employees in a

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[38] Beller, & Lawrence (1992, p. 66).

[39] See, for example, Holden, S., & VanDerhei, J. (2002). *Can 401(k) Accumulations Generate Significant Income for Future Retirees?* Washington, DC: Investment Co. Institute; Samwick, A. A. & Skinner, J. (1998). *How Will Defined Contribution Pension Plans Affect Retirement Income?* Cambridge: NBER.

[40] Holden, & VanDerhei (2002). 401(k) Accumulations, 3, 9–10; Samwick, & Skinner (1998, p. 3). In a later study Samwick and Skinner reached similar conclusions. Samwick, A. A., & Skinner, J. (2004). How will 401(k) pension plans affect retirement income? *American Economic Review, 94.*

firm are compensated according to the same formula. In a defined-contribution plan there are winners and losers. The losers will be those whose contributions do not approach the maximum or whose investments do not perform. The lower one's income the less likely he will contribute a significant percentage of his income and the more likely he will be one of the losers. In 1997 only 1% of employees earning between $20,000 and $40,000 and 10% of employees earning between $80,000 and $120,000 contributed the maximum, while 21% of those earning between $120,000 and $160,000 and 40% of those earning over $160,000 did so.[41] One study found that defined-contribution plans provided a higher level of benefits for the average worker in each income quintile except the bottom.[42]

Nor will every worker within a quintile be "average." Benefits also depend on the worker's choice of investments. Financial advisors insist that only a healthy allocation in stocks will yield returns sufficient for a comfortable retirement. One study noted that "[s]ignificant concerns have been expressed about excessively conservative investments by 401(k) participants, especially women."[43] In 2003, 38% of workers in their 20s and 27% of workers in their 30s – that is, those assumed to have enough time to weather substantial market fluctuations – had no 401(k) funds invested in equities.[44] According to the financial analysts, these workers must change their investing behavior to enjoy an adequate retirement. On the other hand, 13% of workers in their 60s had invested over 90% of their retirement funds in stocks.[45] These workers face significant risk from even a short-term market downturn.

The studies underestimate the risk of defined-contribution plans even for the average worker. For example, one study used two alternate measures to predict returns on 401(k) investments. The first measure was the average return on the Standard & Poor (S&P) 500 from 1926 to 2001, a 75-year period that is far longer than the lifespan of a 401(k). The second measure, presented as a worst-case scenario, was the average return during the S&P's worst 50-year stretch, 1929–1978,[46] still far longer than a typical working life (which itself will often exceed the lifespan of the 401(k), as employees may not participate every year they work) and therefore hardly a worst-case scenario. Another

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[41] Congressional Budget Office (2003). *Utilization of Tax Incentives for Retirement Savings*. Washington, DC: CBO, Table 6.

[42] Samwick, & Skinner (2004). *Defined-Contribution Plans*, 3.

[43] Dafria, A. (2002). The rise in defined contribution pension plans and the stock market boom (p. 1). *Student Research Report*, L. Glucksman Institute for Research in Securities Markets. New York: New York University.

[44] Holden, S., & VanDerhei, J. (2004). *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2003* (p. 9). Washington, DC: Investment Co. Institute.

[45] Holden, & VanDerhei (2004). *Asset Allocation*, 9.

[46] Holden, & VanDerhei (2004). 401(k) Accumulations, 3.

study used the returns on stocks and bonds from 1901 to 1990, or *90 years.*[47]

A period equal to a typical working life would still understate the risk. During the first few years of employment even a worker who contributes the maximum to his 401(k) will not have accumulated a substantial sum. Large returns in the early years are unlikely to provide a secure retirement. Risk is concentrated in the later years when 401(k) assets are greatest, and a relatively brief downturn in the market can have a significant effect on retirement income. From June 1901 to June 1920, a period that may mimic the lifespan of many 401(k)s, the S&P Composite Stock Price Index lost 67% of its real value.[48] On January 18, 1966, the Dow Jones Industrial Average closed above 1,000 for the first time, at 1,000.50. On December 31, 1982, it closed at 1,055.56, a gain of 5% in 17 years.[49] Real stock prices did not reach their January 1966 level until May 1992.[50]

Even far shorter periods pose significant risk. Younger workers, whose annual contributions are a significant percentage of their total 401(k) assets, have seen their accounts continue to grow despite the market collapse of the late 1990s. Account balances for workers in their 50s with more than 30 years of job tenure, however, shrank an average of 9.3% between 1999 and 2003; workers in their 60s with more than 30 years of job tenure saw their accounts decline by an average of 15.5%.[51] Many of these workers will retire soon – or at least had planned to. They have lost their most important investing years and may not have time to compensate.

These workers lacked the most important element: luck. They were born in the wrong year and therefore were employed at the wrong time. In 2003 the Brookings Institution studied the risks of privately funded retirement plans as a substitute for public plans such as social security. All contributors to the retirement plans were assumed to have made identical contributions to their accounts and to have contributed for 40 years. The study found that even slight differences in the particular span of years worked had significant effects on retirement income. For example, an employee who invested 50% of his retirement assets in stocks and 50% in bonds and who worked from 1961–2000 would have replaced approximately 85% of his income. The same employee who worked from 1964–2003 (and therefore suffered the full effects of the recent bear market) would have replaced approximately 55% of his income. An employee who worked from 1936–1975 would have replaced only 30%. Employees who invest all of their retirement in stocks face an even more unequal distribution of

[47] Samwick, & Skinner (2004). *Defined-Contribution Plans*, 15.

[48] Shiller, R. J. (2000). *Irrational Exuberance* (p. 9). Princeton: Princeton University Press.

[49] Pierce, P. S. (Ed.) (1996). *The Dow Jones Averages 1885–1995.* Chicago: Irwin.

[50] Shiller (2000, p. 10).

[51] Holden, & VanDerhei (2004). *Asset Allocation*, 11.

risk. Over the period studied (1912–2003), income replacement rates for these employees ranged from 150% to under 25%.[52]

Under a defined-contribution plan risk is neither collective nor evenly shared. Low-income workers are left behind. For the average worker the system is simply arbitrary. Employees at the same firm, earning the same salary, working the same number of years – investing in the same assets – may end up with drastically different retirements. Some employees may end up with no retirement: although almost all taxpayers are eligible to participate in a tax-deferred retirement savings plan of some kind, in 1997 only 51% did so.[53]

This is only to be expected in a society in which people are told that the purpose of life – indeed, a patriotic duty after September 11 – is to consume, and in which, consequently, personal savings rates are less than 1%.[54] Defined-contribution plans cast a perniciously mixed message: individuals, whose consumption famously accounts for two-thirds of economic activity, must both spend and restrain their spending, since they bear the burden of their retirement. As producers and purchasers workers have fueled the rise of corporate America, and have requested a decent, secure existence in return. For 20 years or more corporations responded. When they ceased doing so the defined-benefit pension was but one of the casualties.

The Abandonment of the Social Contract

Post-World War II prosperity rested on an implicit and occasionally explicit social contract between management and labor. Unions ceded to management almost unbridled discretion over the operation of the firm, and in return management offered rising real wages, employment security, and continually improving working conditions.[55] Corporations and labor unions understood that they would jointly share in the nation's increasing wealth.[56] As one trio of economists put it, the parties entered into a "mutual non-aggression pact" regarding the distribution of wealth, agreeing that the distributive shares of each would remain constant as the economy grew.[57]

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[52] Burtless, G. (2003). *Asset Accumulation and Retirement Income Under Individual Retirement Accounts: Evidence from Five Countries* (p. 31). Washington, DC: Brookings Institution.

[53] CBO, Table 1.

[54] U.S. Department of Commerce Bureau of Economic Analysis (2004). *News Release: Personal Income and Outlays*, December 23.

[55] Gordon, D. M., Edwards, R., & Reich, M. (1982). *Segmented Work, Divided Workers* (p. 216). Cambridge, UK: Cambridge University Press.

[56] Gordon (1996, p. 64).

[57] Bowles, S., Gordon, D. M., & Weisskopf, T. E. (1998). *Beyond the Waste Land* (p. 84). Garden City: Anchor Press-Doubleday. For additional discussion of the social contract see Reich, R. B. (1993). *The Work of Nations* (pp. 67–68). New York: Knopf; Reich, R. B. (2002). *I'll Be Short* (pp. 11–14). Boston: Beacon Press.

For more than two decades the social contract held. Between 1947 and 1967 real wages of workers in core manufacturing industries grew by more than 3% per year while unemployment fell below 2% at the height of the boom and workers began to take employment security for granted.[58] Although wage growth slowed in the early 1970s real wages continued to rise.[59]

For 25 years after the war the United States dominated the world economy. Since the 1970s American corporations have been subject to fierce global competition, and have responded by slashing pay and benefits and turning workers into disposable commodities. From 1973 to 1979 real wages for manufacturing workers grew by only 0.26%.[60] From 1980 to 1989 real wages fell more than 9%.[61] In real terms, the average worker earned less in 1987 than in 1979.[62]

But globalization alone cannot explain this reversal. Corporations ceased sharing the nation's increasing economic bounty with their workers. During the 1980s real production wages fell by 0.6% per year even though productivity increased by 1.2% annually.[63] In 1973, 56% of total national income was paid to employees as compensation: 40% to production workers and 16% to supervisory employees. By 1993 the share of national income paid to employees had increased only slightly, to 58.6%. Supervisory employees, however, had increased their share by half, to 24%, while the share paid to production workers had declined to 34.5%.[64] The non-aggression pact was dead. Management's increased wealth derived almost entirely from a redistribution of income from production workers.

CEOs have especially benefited. During the 1980s, after-tax CEO salaries increased by two-thirds in real terms while production workers' real hourly take-home pay declined by 7%.[65] In 1982 the ratio of CEO pay to average production worker pay was 42-to-1; in 2003 it was 301-to-1.[66] Between 1990 and 2003 CEO pay increased 315%; the S&P 500, 237%; corporate profits, 144%; and production worker pay only 48%.[67] If globalization was the original impetus for the demise of the social contract it has since become an excuse.

Or, to be precise, it has become a threat. Job security has disappeared as corporations have outsourced jobs and turned to temporary and contract

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[58] Gordon, Edwards, & Reich (1982, p. 217).

[59] Gordon (1996, p. 19).

[60] Gordon, Edwards, & Reich (1982, p. 218).

[61] Mishel, L., & Frankel, D. M. (1991). *The State of Working America 1990–1991* (p. 69). Armonk: Sharpe.

[62] Mishel, & Frankel (1991, p. 71).

[63] Gordon (1996, pp. 68–69).

[64] Gordon (1996, pp. 81–82).

[65] Gordon (1996, p. 34).

[66] Anderson, S., Cavanagh, J., Hartman, C., Klinger, S., & Chan, S. (2004). *Executive Excess 2004* (p. 22). Washington, DC: IPS and Boston: United for a Fair Economy.

[67] Anderson, Cavanagh, Hartman, Klinger, & Chan (2004, p. 23).

workers. Economist David Gordon has estimated that by 1995 approximately 10% of the private workforce consisted of "contingent workers" – temporary workers and those working involuntarily either part-time or as contractors, on-call workers, or day laborers.[68] A study by the Economic Policy Institute concluded that in 2001, 27% of American workers were in the contingent workforce (not all involuntarily).[69] Another study found that the percentage of major multi-national corporations whose workforce consists of at least 10% contingent workers increased from 12% in 1990 to 21% in 1995.[70] In 1993 1.7 million people worked as temps for agencies such as Manpower;[71] before being overtaken by Wal-Mart, Manpower was briefly the nation's largest employer.

With corporations prepared to move operations wherever they can operate most cheaply, workers have little leverage to demand higher wages, and management faces little internal pressure to reward its employees. CEOs at the 50 largest outsourcers of jobs were paid 28% more in 2003 than was the average large-company CEO; the outsourcers received, on average, a 46% increase in compensation in 2003, compared with 9% for the average CEO.[72]

The threat of job loss has also allowed corporations to demand "give backs" from unions – the reduction of health care and other benefits. The number of workers in medium and large firms with employer-provided health care plans fell from 97% in 1980 to 76% in 1997.[73] Only 14% of contingent workers have health care;[74] consequently, as the contingent workforce grows the percentage of workers with health care can be expected to decline further.

Employers have reduced other benefits as well. Between 1980 and 1997 the percentage of medium and large firms offering paid holidays decreased from 99% to 89%; paid sick leave, 62% to 56%; and paid vacation, 100% to 95%[75] (and to 87% in 2003).[76]

The substantial decline in union membership has allowed management to renege on its pact with labor. But management has also abetted that decline. Corporations not only ceased sharing economic gains with labor but began active warfare against the labor movement. In the 1970s corporations turned to private management consulting firms that specialize in union breaking and

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[68] Gordon (1996, pp. 226–227).

[69] Wenger, J. (2003). *Share of Workers in "Nonstandard" Jobs Declines.* Washington, DC: EPI, Table 1.

[70] Sweeney, J. J. (1996) *America Needs a Raise* (p. 36). Boston: Houghton.

[71] Gordon (1996, p. 224).

[72] Anderson, Cavanagh, Hartman, Klinger, & Chan (2004, pp. 4–6).

[73] Jacobs, E. E. (Ed.) (2001). *Handbook of U.S. Labor Statistics* (p. 286). Lanham: Beacon.

[74] Wenger (2003), Table 4.

[75] Jacobs (2001, p. 286).

[76] Lewis, D. E. (2004). Trips, Hobbies Offer Balance to Stress in U.S. Workplace, *Oregonian* [Portland] November 28 sunrise edition: G2.

union prevention and resisted unionization in their new plants in the South.[77] The incidence of companies illegally firing workers for trying to organize unions more than doubled from the late 1970s to the early 1980s.[78] According to one survey, decertification petitions per union member tripled between the 1960s and the early 1980s, as did worker complaints of unfair labor practices.[79]

It is against this background that the decline of the defined-benefit pension system must be understood. This system enjoyed a fitful existence from the late 19th century until the end of World War II, then spread along with post-war prosperity and reached its heights in the 1960s and early 1970s as both state and corporation assumed new responsibilities. It declined with the retrenchment of the 1980s and beyond as reactionary forces began to resist the sharing of both wealth and risk. Management began retaining increases in wealth for itself and for the shareholders. At the same time the elimination of health care plans and job security returned the risks of illness and unemployment to individual employees.

The shift to defined-contribution plans works the same reversal for the risks of retirement. Prior analyses have addressed this shift in a vacuum, ignoring the broader economic changes that were occurring simultaneously. Attributing the shift merely to the "preference" for defined-contribution plans by service-sector employers ignores the crucial role that unions played in the rise of the pension system and the powerlessness of non-unionized workers to insist on a secure retirement. Attributing it to employee preferences for defined-contribution plans is even more myopic. Employees struggling to hold onto their jobs, their health care, even their holidays and vacations are in no position to engineer an upheaval in the pension system. If workers have accepted defined-contribution plans it is because all many of them know, and because it is they have been relentlessly conditioned to believe that individual retirement plans are superior to a shared plan. The evidence suggests otherwise; but sharing requires a social contract, and an ethic, that no longer exist.

Conclusion

The ethic of collective security has its roots in the DEPRESSION, when a sense of mutual vulnerability led to a belief in mutual obligation. The socialization of risk that began with state programs such as SOCIAL SECURITY expanded to the private sector after the war, as prosperous corporations concluded that they could sustain employee wealth without diminishing their own. But

[77] Gordon, Edwards, & Reich (1982) p. 219.
[78] Reich (2002). *Short* (pp. 14–15).
[79] Gordon (1996, p. 207).

within a generation the ethic began to dissipate as changing world economic conditions convinced management it was playing a zero-sum game in which it must choose between employees and shareholders. It chose the shareholders – and itself. The ethic of collective security that briefly socialized the costs of illness and retirement is gradually yielding to a radical individualism under which each employee is once more on his own.

Corporations would have employees believe otherwise, and even many independent observers have been fooled. Although defined-contribution plans offer no guarantees and no fixed payment – and in some cases no employer contribution – they have come to be called *pensions.* Academic papers ask, "How Will 401(k) Pension Plans Affect Retirement Income?" and address "The Rise in Defined Contribution Pension Plans and the Stock Market Boom." Defined-contribution plans are not pensions: they are savings accounts. A portion of the employee's wage is set aside; the difference between a 401(k) and a forced savings plan is the tax deduction. The employer contribution, if any, is additional salary.

This diversion of salary masquerading as a pension has led to an unappreciated irony. Employees have been convinced that they must bet their retirement on stocks, and in large part most do so. Even before the rise of the defined-contribution plan many employers invested pension funds in stocks. But employees whose retirement was based on a strict formula never concerned themselves with the employer's investments; as management guru Peter Drucker observed in 1976 concerning the substantial ownership of stocks by major pension funds, "employees own American business; but they do not know it, do not perceive it, do not experience it."[80] Today's employees are acutely aware of their stock ownership, and they increasingly view a rising stock market as their friend. Hence the irony: employees have been led to identify their interests with those of corporate America just as corporate America is abandoning them.

The social contract recognized that management would operate the firm to increase profits. But the purpose of the corporation is not profit. Society created the corporation to serve the public good. Profit is the means to this end. The social contract held for a generation because corporate America's focus on profits benefited everyone: shareholders, employees, and communities. For a quarter century these groups shared risk and reward. Today's singular focus on short-term stock prices and quarterly profits too often benefits only the shareholders – or management. A renewed social contract will require that we recover the real purpose of the corporation and restore an ethic of mutual obligation.

[80] Drucker, P. F. (1976). *The Unseen Revolution* (p. 97). New York: Harper.

3

Corporate Retirement Security: A Bankrupt Oxymoron

Patricia H. Werhane

Employment contracts are ordinarily implicit or explicit agreements between employees or managers and employers. Most contain "at will" provisions. Many imply or entail imperfect obligations or promises of employment conditions and benefit opportunities that permit revision or abrogation of the contract agreement under conditions of exigency, however specified or implied.

Pension plans are ordinarily explicitly spelled out in employment contracts and agreements. Pension plans, like other employment agreements, unless otherwise specified, can be altered or even stopped. However, while this and other employment agreements are by and large revisable promises that entail imperfect moral obligations, I shall argue that sidestepping pension payouts to existing plans to which contributions have already been made is a violation of a perfect moral obligation, that is, it is just wrong. In fact, I shall argue, in most cases to do so is a form of stealing compensation from present and former employees.

I shall offer a solution that does not entail more government payouts. I shall conclude, however, that what is called for is not this or any other patchwork solution to the present system but rather, a different mental model for employment.

In the "olden days," fondly remembered as the "good old days" there was a myth that managers and other employees working for large corporations had implicit employment agreements. These agreements allegedly guaranteed lifetime employment, pensions, and lifetime healthcare coverage for loyal decent managers so long as they did not blatantly lie, cheat, or steal from the company. A paternalistic mindset was extant or thought to be extant, and no one in that protected class felt threatened. This Golden Age of employment probably existed only in the 1940s and 1950s. In the 1940s, during the World War II, the United States enjoyed full employment, and even women and minorities had no trouble finding jobs. While these equal opportunities abated after 1945, economic growth in the 1950s provided almost full employment at least for white male managers and employees working for large companies (no

more than 20% of the workforce), and they enjoyed what appeared to be lifetime employment.

In fact, however, the good old days were good only for those in management positions in large profitable companies, and accounted for only 20% of the working populations. Moreover, pension obligations were not always honored nor recognized in the courts as valid agreements (e.g., *Hablas v. Armour and Company*, 1959). Still, there was the heartfelt myth that if you did good work, you would be virtually guaranteed a job until retirement. And the organization of workers into unions, accounting for up to 20–25% of all workers, created good and almost guaranteed jobs and pension plans for those employees as well.

Of course the Golden Age was not so golden for women and minorities who had, at best, lower paying jobs, some of which had none of these guarantees, nor was it perfect for those who were contingent workers, that is, independent entrepreneurs or professionals, or part-time or contract employees with no benefits whatsoever.

The exception was and still is full-time employment in the public sector (e.g., teachers in public schools, public sector hospital workers, civil servants, the military, and others) in local, state, and national governmental positions whose pensions and other benefits by and large were and are governmentally assured. This sector accounts for over 40% of all civilian employees.

Today these implicit paternalistic lifetime contracts have virtually disappeared in all sectors of the economy. Still, according to the *Chicago Tribune*, at least 25% of all employees and managers in the private sector pay into pension plans that are supposedly guaranteed either by implicit or explicit contracts to pay out when one retires (Rose, 2005, 5 pp. 1, 4).

Whether or not my description of the good old days was accurate, myths still exist fondly describing this Golden Age, which of course, if it ever existed, is no more. Intense internal and global competition and outsourcing to other countries have reduced significantly unionized skilled workers. According to a recent *New York Times* article, in 2004 under 12% of all workers belonged to unions (Bai, 2005, p. 38). This competition and outsourcing and the plethora of mergers and acquisitions have destroyed the hope of lifetime employment for all but the most naïve managers in the private sector. The number of part-time and contract employees and managers who have no company benefits whatsoever is increasing. Moreover, trust and loyalty in one's employer has been on a steady decline such that "current relationships between employees and organizations are [now] characterized by lower commitment, respect, and trust" (Scandura & Williams, 2002, p. 169). As one writer has baldly stated it as early as 1996, "organizational trust has hit rock bottom" (Caudron, 2002, p. 187). At the same time, those employees and managers with pension plans have made the rash assumption that at least what they have paid into the plan

and/or have been paid in by their employer, under ERISA protection, are safeguarded funds.

There are various discussions of the comparative value of different pension plans, 401(k) plans, defined benefit versus defined contribution plans, etc. I am not going to discuss the relative ethical or financial merits of these. Rather I want to focus on the philosophy and moral obligations of the plans themselves. A pension plan, at least in the private sector, is often thought of as an enhancement of employment, a benefit, and thus, like many company benefits contributed or partly funded by the company, a form of a gift, something given to employees like a bonus, that, in hard times can be reduced or rescinded. But pension contributions are not bonuses, nor indeed, should they be thought of contributions in the ordinary sense of that term. Pension plans usually are created from a combination of employee and employer funding, or in rare instances only the employer or the employee puts money in the plan. But why do employers create and fund these plans? Because they are benevolent, love their employees, and want to take care of them or reward service to the company? Maybe, but that is only part of the story. Pension plans are created as part of compensation so that the company is competitive with other companies in attracting and retaining employees. They have become so much a part of new hire expectations that we have sometimes forgotten why they were created in the first place. While it is true that most companies fund or help fund and sometimes manage these plans, the alleged contribution is really deferred compensation with the promise of pay out when the retiree leaves the company. So the term "contribution" itself, a word usually reserved to refer to charitable donations, is a misnomer. A contribution is ordinarily a voluntary gift that is contributed at will without any stipulations. But funding a pension is a form of paid-in compensation. Pension funding is like a contribution or a gift in one sense, however. Once given, one never expects to get a gift back; so too, pension funding, once contributed, should carry with it the same expectations.

Companies who control their employee pension plans may argue that as fiscal agents they *should* have control of these funds, since after all they have contributed least part of those monies. In difficult fiscal times, such monies are often needed to keep the company in business and thus avoid unemployment for those who have contributed to the plans.

These may sound like solid arguments, but they stand on swamp ground. The reasons are obvious. Even if a company is the fiscal agent for its pension plans, the monies, both the employee and the employer's contributions, are part of an employee's compensation. For employees who contribute to these plans, the money comes out of their base salary. For companies that contribute, this is part of the compensation package. Thus a company has no rights to these funds, they are not theirs. Fiduciary agency does not equate to rights to

use those funds for any purpose other than paying out pension benefits. Fiscal use OR misuse of them is tantamount to stealing.

Let me put it another way. Companies, like individuals, have obligations. Some of these are imperfect obligations, for example, to be nice to employees, to give to the community, or when not contractually or legally required, to increase wages or pay bonuses. Other obligations are perfect obligations, the violation of which is always wrong. Promise-keeping is usually considered almost a perfect obligation, although there can be exceptions when life, rights, or well-being are at stake.

Stealing is one of those perfect obligations. No company of any worth would think of stealing from its customers, its shareholders, or the community. Similarly, if asked, almost every company would say that it never steals nor would it, from its employees. Yet taking funds from pension monies is taking committed, paid-into, and deferred compensation from employees.

A company might argue that, like in cases of promise-keeping, exceptions may be made in times of economic exigency in order to keep the company from closing its doors. But contractual paid-out compensation is more than a promise; it is a promise or commitment that was fulfilled. Thus using those funds is stealing from employees.

Most pension managers will disagree with my conclusion, arguing that the difficulty is in the actuarial funding of the pension plans, because the ultimate total payouts (not the contributions) are often more than the sum total of contributions, given longevity, etc. This IS a difficulty. Interestingly, however, TIAA-CREF, the retirement and annuity fund for many teachers, administrators, and university professors, does not seem to face that difficulty, perhaps because of better actuarial tables, a larger contributor base, and parsimonious investments of the contributions. TIAA-CREF, of course, has only one mission: to safeguard and payout these retirement funds. But it has no obligation to pay more than the earned contribution (in 2001, e.g., when the market fell, annuity payouts fell as well). And perhaps this is the difficulty: TIAA-CREF offers defined contribution plans. Other companies that are in trouble are so because their original pension plans were defined benefit plans, promising a certain payout however the pension funds fared in the meantime. Have companies adequately funded, segregated, and protected their pension fund contributions? And do we as employee–pensioners expect to receive a full pension even if its invested value has decreased? Even when pension plans are underfunded, nevertheless they were created by supposedly intelligent people whose actuarial know how should have predicted these underfunding outcomes. Moreover, however the financial status, pensions are promises for future salary. Thus there is a moral obligation built into a pension plan that is offered and accepted.

Of course, employees can be given the option to contribute their pension funds to the company or to use that money to buy company stock, but that

should be the choice of each employee, not of the employer. Employers can change or discontinue their pension plans, unless contractually required to do otherwise, so that there is not a perfect obligation to *continue* funding a plan, but there is a perfect obligation to pay out what has been contributed and promises up until the discontinuation.

To ameliorate pension bankruptcy problems, the U.S. government has formed the Pension Benefits Guarantee Corporation (PBGC). This organization is funded from insurance premiums from employers that sponsor insured pension plans and from pension plans it takes over. In emergencies when a company wishes to terminate its pension plan or when it cannot pay all pension benefits, the PBGC takes over, covering the difference between the company's funds and the pension benefits to be paid out. However, according to their web site, the maximum pension benefits PBGC pays out for plans ending in 2005 is $45,613.68/year per claimant for those retiring at 65. The amount is lower for early retirees and more for those who retire after 65. How does that affect employees? Ken Bradley, a retired United Airlines pilot who has a six-figure pension, had to retire at 60, the maximum flying age for pilots. Because the United Airlines pension fund had declared bankruptcy (and the courts have approved!), Bradley will now receive only $29,649 from the PBGC (Rose, 2005, p. 4; Skertic, 2005, p. 1). Moreover, it is estimated that the PBGC will soon have a fund shortfall of up to 1 billion dollars if companies continue to underfund their pension plans. So we as taxpayers could soon be the payers as well as the beneficiaries of the PBGC. This is unfair. It is not unfair that taxpayers help citizens in need; but in this case it is unfair because of mishandling of paid-in monies.

There is another fairness issue. Senior management of some, but not all, large companies is extremely well paid. So these executives could manage on a pension of $29k or $45k thousand a year, given their other savings. Other employees who have lower incomes are not so lucky. I am not suggesting a Robin Hood argument that it is all right to steal pension funds from the well-to-do to give to the poor pensioners. Rather, that depleting pension funds hits the middle-paid worker the hardest. And sometimes the managerial judgment to use pension funds or neglect to pay into them comes from the top executives in the company, the very people whose retirement package is less a critical matter than lower-paid employees and workers.

The formation of the PBGC was an outcome of the 1974 ERISA law that guaranteed the vesting and transfer of pension funds when one changed jobs. This was an important act because it prevented employers from keeping pension monies of 10-year employees who had quit or were fired. The PBGC was also formed to guard against loss of pension funding when a company could no longer pay into a fund. This sounds like a "good thing" to do, and no one wants employees to lose their benefits. However, the looseness of allowing companies

to forfeit their pension funds has led to the problems facing employees and the PBGC. At least 22% of the top Fortune 100 companies are failing to meet their pension obligations. At this rate PBGC will itself be bankrupt or require additional taxpayer funding (Rose, 2005, p. 1). Are companies becoming dependent on PBGC to bail them out? And are pension-funded employees developing this expectation as well? There is something wrong with this picture.

So what is to be done? There is a patchwork solution to this morass of problems. Let me give an example to illustrate. Professors and other employees at universities usually (but not always) have a choice of where their pension contributions and those of their employer will be invested, and one of those choices is TIAA-CREF, an independent family of funds. This family of funds is run completely independent of any university employer. Now of course TIAA-CREF could go bankrupt, although its conservative investment policies make that unlikely. The point is that it is independent so that the temptation in hard times to use those pension funds is not available to university employers. Why not create such independent funds for private corporate employers, requiring that all pension monies be invested outside the company, far from sticky "hands." The funds could be governed by employees themselves or by the PBGC. Since Enron most companies today restrict the number of company shares that can be owned by their pension plan. Why not make the plans completely independent? This would protect the employee from corporate use of its money and be no more risky than the present corporate control of these funds. PBGC could still guarantee these funds just as the FDIC guarantees deposits, but that might greatly reduce the taxpayer and PBGC liability.

The Bankrupcy of "Corporate Retirement Security"

According to the *Chicago Tribune* "fewer than 20 percent of private sector workers are covered by traditional pensions, down from 35 percent in 1980" (Rose, 2005, p. 4). PBGC plans cover 44.4 million workers in various pension plans. This is out of total employment (part-time and full-time) in the United States of 140 million in December 2004 (bls.gov, 2005); 7.8 million of these have more than one job, so adjusting for them and rashly assuming that these folks are covered by at least one PBGC covered pension plan (which in fact is not true) at a minimum, and adjusting for the 70 million of the 140 million workers who are in the public sector, over 35 million workers who may or may not have pension plans, have plans that are not protected by the PBGC. At least a third of these 35 million people is part-time or contract employees with no benefits whatsoever.

So we have a pension plan system guaranteed by our government that only covers about 31% of all workers! Moreover, that system is under threat by those companies who have bankrupted their pension plans. Thus we have a

government corporation that does not cover all future and present pensioners, we have a pension system that only covers full-time employees with a few exceptions (there are some part-time employees in some companies such as Starbucks that have pension plans), and none of these, the private sector or the PBGC, covers all full-time workers not all the investments of previously. Thus the idea of retirement security in the private sector, a sector that accounts for at least 50% of all employment, is a myth for at least half of those workers (if one counts the part-time and contract employees) and a declining benefit for those whose companies programs are covered by PBGC but who are in fiscal trouble.

Another Model[1]

In thinking about employment and thus pension plans, it is tempting to focus on managerial/employer responsibilities to employees, as if employees are dependents on companies. This is a leftover mindset from the Golden Age myth. But no individual in a free commercial society is defined completely by the set of organizations in which he or she participates. Every worker, employee, or manager, in every sector of the economy, is free to leave his or her job at any time. Moreover, each of us has responsibilities as well – responsibilities not merely to employers, but to him- or herself and his or her future, and to manage that future, as he or she is able and sees fit. This is particularly and acutely the case in the post-Golden Age of employment and pension insecurity.

Employees are, or should be, responsible for their own lives and careers, and, they need to take the steps necessary to research and explore mobility options and to control their own pension contributions. We are thus challenged to try to reformulate the notion of employment proactively from an employee perspective – to create a mindset of the employee as *professional*.

The demise of employment security and now the threat of the demise of pension security for every person in the private sector should prompt employees and managers to rethink who they are – to manage their own careers and even to rejoice in the demise of paternalism. This requires changes in the "boss" mental model, so aptly exploited by Dilbert, and altering our vision of ourselves from that of "just an employee" to that of an independent worker or manager with commitments to self-development (Hirsch, 1987).

But how, in the 21st century, is a person to develop this sort of independence and independent thinking about his or her work, when the vast majority of us work for others? The cards are stacked against such thinking. Since

[1] This section is revised from an article written with Tara J. Radin (Radin & Werhane, 2003; Werhane et al. 2004).

childhood we have learned to be obedient and we have been taught that obedience is a virtue. This paternalistic model of employment is not an anomaly but a continuation of a mindset, albeit bankrupt, of early training and cultural inculcation.

Although there appears to be little in our backgrounds to assist us, historically that is not true. One of the great debates in the United States during and after the Industrial Revolution concerned the status of "free labor" versus "wage labor." Free labor was considered "labor carried out under conditions likely to cultivate the qualities of character that suits citizens to self-government" (Sandel, 1996, p. 169). Such conditions included economic independence, and thinkers such as Thomas Jefferson associated free labor with independent farming. Wage earning was thought by some to be equivalent to slavery since it "denied [workers] economic and political independence essential to republican citizenship" (Sandel, 1996, p. 172). The authors of *Rerum Novarum* (1892), the first Papal social encyclical, subsequently qualified the admonition about wage labor, and proposed that wage labor was not a form of slavery when workers were paid adequately. By "adequately," the encyclical did not mean merely a living wage, but a wage that would provide enough "leftover" so that the laborer could become a property owner as well. Thus the notion of free labor and worker independence is not without precedent.

The model we propose is that of employees as *professionals.* "Profession" refers to "any group of individuals with particular skills who work from a shared knowledge base" (Spencer et al., 2000, p. 71). A professional is a person who has trained skills in certain areas that position that person as employable in his or her area of expertise. A professional is identified with, and has a commitment to, his or her professional work. It is the work and its achievements that are important, even more important than the workplace setting. Indeed, for some professionals it is the work and its contributions that are more important than its monetary reward. Additionally, most professionals belong to independent associations that have their own codes of professional ethics and standards for expertise and certification or licensure (Bayles, 1981).

The responsibilities of a professional are first to his or her expertise, second to his or her profession and the code of that profession, and only third to his or her employer. This is not a model of the "loyal servant," but, rather, of a person who manages him- or herself with employable and retrainable skills that he or she markets, even as he or she may simultaneously be in the employment of others. This is a person who commits to excellence and a particular set of professionally defined moral values in whatever employment situations he or she encounters, but is not wedded to one employer or one particular job. Professionals are persons who can work in many settings that draw on their expertise. Indeed, it is the expertise that they carry from job to job that distinguishes their work as "free labor."

Outside the traditional professions the professional model is one that has developed primarily in the high tech and dot.com industries, as people with specialized skills have built firms around those skills. In a recent article Alan Hyde, a student of what he calls "high velocity labor markets" (where employees change jobs regularly) such as in Silicon Valley, outlines the professional model in that industry. While Silicon Valley employees have not officially organized themselves into professional organizations, a number of qualities distinguish this set of employees. Although these employees are well trained and well compensated, the turnover rate at most of these companies is up to 35% per year. Employees switch between companies, exchange informal information through a vast Internet network, and carry their knowledge base with them to the next position.

Hyde indicates that Silicon Valley employees manage their own careers within a network of companies, instead of focusing on just one (Saxenian, 1994. 3–4, report in Hyde, 1998, p. 223). Hyde posed a question to these professional employees:

> Suppose … that there were an organization … that did the following things. It contracted with the large health maintenance organizations in your area for coverage for you and your family whether or not you were employed at that minute. It provided advice and perhaps administrative services on your 401(k) retirement plan. It lobbied in Washington and Sacramento on issues related to professional employment, such as tax aspects of 401(k) plans. It maintained a web site, user lists, and chat groups for exchange of information about employers, where the jobs were, what was the employer's reputation, did it sue department employees, etc. Finally, it might provide training or offer other courses.
>
> Hyde (1998, p. 227)

While the model Hyde postulates is formulated within a particular context, it is one that easily could, and should, be emulated elsewhere, as Hyde himself suggests. The growth of high tech firms offers an excellent example because, through these ventures, people have been able to focus on their talents, even as employees have moved from company to company, because employees are valued for their skills rather than their loyalty. High tech firms are not models for all employment, since they are often narrowly tailored to offering particularized products and services, but they do stand as potential models for other areas of employment.

There are other opportunities for professionalism as well, particularly with regard to contingent workers. During the past 20 years we have witnessed what some label as an alarming trend – the increase in contingent workers – workers who work part-time, or full-time on a contract basis without insurance, pensions, or other benefits. Contingent workers include self-employed, voluntary

part-time workers, contract workers and consultants, and homebound workers. These workers range from dishwashers to professionals and managers. Many have chosen this sort of employment arrangement – some of these people have benefits independently or through spouses, and they thus appreciate the enhanced flexibility and higher salaries as compared to their full-time counterparts. Many others resent their "contingency." There are many, who, according to Brockner and Wiesenfeld, see themselves as "peripheral" to the organization, particularly those who are part-time, contract, short-term, or "disposable" workers (Brockner & Wiesenfeld, 1992).

These workers are independent contractors – "free labor" in Jefferson's sense of the term – even though many of them do not revel in that. They are thought of, often, as "disposable," and some are involuntarily contingent workers, subject to a number of injustices including no pension plan opportunities.

Given the psychological pressures and perception of second class citizenry, involuntary contingent workers in companies tend to be less loyal, less productive, and exhibit lower morale – all of which hurts the long-term productivity and well-being of the company for whom they work. At the same time, contingent workers are not as vulnerable to some of the problems that hinder full-time workers. Contingent workers are less likely to be absent, drink or use drugs on the job, complain, snooze, schmooze, or engage in time-consuming office or work floor politics. Moreover, without union protection they are unencumbered by work rules or traditions. They are, therefore, more flexible.

As the number of contingent workers increases, those who choose this path as well as those who are involuntarily forced into it should be able to develop a sense of independence, engendered by redefining themselves in relation to their work. Using Hyde's model, this could translate into a rise of professionalism. Because contingent workers are no longer linked to particular companies, it could lead to a shift of loyalty from the company to work and to the profession. In addition, it could lead to the formation of new professional associations – associations, not necessarily industry- or position-specific, which develop guidelines for skills, licensing, and conduct, form employment contracts, develop codes of conduct, and protect members, just as the legal, medical, academic, and, to some extent, the engineering professions do today. These professions, then, could gain leverage, just as unions have done in the past, with employers, with leverage translated into equal pay for equal work and professionally provided benefits and pensions.

But what about unskilled low-wage workers? Interestingly, in a few studies by Dorothy Sue Cobble, waitresses who organized themselves by craft, even though waitressing is relatively unskilled, developed a sense of dignity and pride in their work (Cobble, 1991; Wial, 1993). Like these waitresses unskilled workers would have to change their own mindsets about employment. It would require rethinking of themselves as independent contractors with

trained or trainable skills that are transferable to a number of job settings, rather than as mere wage earners. By taking their work and productivity contributions seriously and banding together, workers with such mindsets would create economic value added for firms and a sense of self-worth.

This model of professionalism requires changing mindsets of employers as well. In a recent article in *Across the Board*, a journal aimed at CEOs and boards of Fortune 1000 companies, Thomas Davenport argues that this mindset revision is necessary and valuable for employers as well as employees. Davenport is critical of measuring employees as costs or as assets. That metaphor, he argues, is outdated (if it ever applied at all) and creates a vision of employees as passive phenomena to be deployed, like the assets we buy and sell. Davenport's model is to view employees as investors who make a human-capital investment of their productivity into a particular company. According to Davenport,

> Conceiving of workers as investors rather than assets emphasizes that the link between employee and company depends not on ownership, paternalism, or blind loyalty. Instead, the cord binding organizations and people derives form the ability and willingness of each to provide benefits to the other. The relationship assumes mutual benefit, with neither party elevated at the expense of the other.
>
> Davenport (2000, pp. 32–33)

My argument is that professionalization of employees, all employees, helps management to conceive of employees as value creators, as creating specified kinds of value that they "invest" in companies, companies in which they may or may not choose to invest for a lifetime. Healthcare plans and pension funds would be set up independent of a particular employer just as some professionals even today set up these funds, although some employers, in order to be competitive, will contribute to these funds. These plans could be guaranteed by the PBGC but controlled by independent boards of directors. In return, companies will get better trained, more efficient and productive employees who take their professional expertise seriously as a life commitment. Employees, like those of us whose pensions are funded through TIAA-CREF, would expect no more (but no less) than we and our employers had contributed. Does this sound like the Bush plan for social security? I would contend that social security should be left alone as the guarantor of some bottom-line pension monies for almost everyone – the last bastion of security in a dramatically changing political economy.

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4

Trust, Portability, and Sustenance in Pension Plans

Robbin Derry

Will I have enough money in retirement to live comfortably and pay my bills? Can I leave this unsatisfying job and take another without losing 15 years of retirement savings? The company has told me for decades that my pension plan is secure – now suddenly they are on the verge of jettisoning the plan, my secure plan, so the company can survive. But how can I survive, how can any of us, who have put our sweat into this company, survive long without our promised pensions? As the previous articles by Sloan and Gavin, Bennett, and Werhane (this volume) remind us, the important questions for individual pension holders in the midst of the current upheaval in corporate pension plans are about trust, portability, long-term survival, and the ability to provide for oneself and one's loved ones. Employees signed onto fair deals and believed their employers had made a firm commitment to fulfill promises. Now the rules are changing and the old promises abandoned. Where will any of us, particularly the least advantaged, find the resources and security to live and thrive in retirement?

These essential questions are, for me, questions about nurturance and sustenance. Nurturance and sustenance are, from the perspective of a bread-baking mother of young children, about good, healthy food. Cooking, feeding, nurturing – these are concepts I understand thoroughly. As a former restaurant chef turned ethicist, I have strong feelings about reliable sustenance. It is perhaps not surprising that questions about long-term care and survival lead me into metaphors of food preparation. In attempting to make sense of the debate about where pension plans are headed, how worthwhile each plan is, and what its impact is on individual well-being, I explore here insights from the world of family meals. Food isn't a perfect substitute for pensions, but hopefully the analogy will provide something to chew on.

Okay, you may be saying, I can make the leap to food with questions of long-term survival and providing for oneself, but how do trust and portability fit in? Remarkably, we forget how much trust is required of us when we eat out, which is where Americans eat more than 60% of their meals. Trust that health code officials have done their job properly, trust that employees remembered to wash their hands, trust that the antibiotics given to cattle and

chickens were proper doses of safe drugs, trust that no competitor has infiltrated the kitchen to taint the entrées, trust that the kitchen staff remembered to put away all the unused food at night, trust that the chef threw out the meat that was in the refrigerator when the power went off in the storm: all these considerations remind us that we are trusting our lives and health to others when we eat food that others have prepared.

Similarly, when we bank our future security on pension plans overseen by managers with a multitude of obligations other than our long-term sustenance, we are engaging in a trust relationship that we would do well to recognize. We are entering an arena full of rocky history, misjudgments, loss, heartbreak, bankruptcy filings, and disillusioned individuals. Just so, in entering a restaurant, we encounter an arena of regretted consumption, short-lived sugar highs, obesity, and overpriced, oversold images of satisfaction.

Portability? One only need to look at the images of frantic mass migration in the wake of hurricanes Katrina and Rita to recognize the importance of the portability of food, savings, and one's independent ability to care for oneself to see that these are all fundamentally linked to our survival. In 21st century society, we must be able to pick up and move – to a new job, to a new home, to a new community, and still be able to provide for our families over the long term. As Werhane points out, pension plans that are not portable are woefully inadequate to meet the needs of today's workers. And while most people don't feel the necessity of carrying healthy food with them to ball games, or on airplanes, our public health might be well served if we did. Portability of critical assets is essential for sustenance.

Pension Plans: The Entrée

The three authors examine the ethical issues of pension plans from contrasting angles. Pursuing the metaphor of family meals, we can think of pension plans collectively as an entrée carefully prepared and served on a platter for our scrutiny. Sloan and Gavin introduce us to the dish with its recent culinary development, popular appeal, and the advantages and disadvantages of different preparation techniques. Bennett enlightens us with historical insights of this entrée's evolution from antiquity to modern times, demonstrating its contribution to social stability, and a well-fed populace. He critiques his least favorite ingredient, a recent substitution to the classic preparation of this dish. Werhane is not sure she likes either the dish or the style of preparation.

I like to think of pension plans as Turkey Tetrazzini. My mother, a single parent and high school teacher, taught me how to make Turkey Tetrazzini when I was in middle school, so if I arrived home before she did I could start dinner for the family. I called it Turkey Tetrazzini a la Dorothy. The ingredients were boiled

spaghetti noodles, left over cooked turkey or chicken, cut into chunks, and a can of Campbell's cream of mushroom soup. That's all. Sometimes I threw in a package of frozen peas just for color. Mix together and bake at 350 F for an hour.

Originally, Turkey Tetrazzini was made with noodles, freshly cooked poultry, homemade cream sauce, vegetables, and perhaps some breadcrumbs and paprika sprinkled on top. Every cook knew that those ingredients were essential to their family's well-being, sustenance, and happiness. The benefits were clearly defined. That was in the good old days.

Then along came Campbell's Cream of Mushroom soup and soon everyone believed that the final product was just as good (if not better) when you saved time by opening a can of the dense gelatinous goop, mixing it into the noodles along with one or two other ingredients, popping it into the oven, and no one would ever know the difference. It would be one more casserole dinner, sure to please, and after all, getting dinner on the table was the important thing. Defined contribution without the defined benefit of a well-fed family.

In their discussion of pension plans, Sloan and Gavin explain the nutritional values of all the ingredients. Defined benefit plans were traditionally trustworthy, but not portable. They were trustworthy because the companies bore the entire investment risk. Mom would always have food on the table at home for us; but no, we were not offered a long-term stipend, so we could eat dinner out wherever and whenever we wanted. Dinner was provided at home. Defined benefit plans stopped being trustworthy when companies realized that they couldn't afford to continue to absorb all the market volatility and pay out pensions for decades. Eventually Mom got tired of feeding everyone at the drop of a hat, and besides she needed to work and earn a salary to pay the bills, including our food bills. So the preparation short cuts looked like a good idea. Mom could go back to work, and we could still have dinner together.

But Barry Bennett tells us that cream of mushroom soup isn't really worth much nutritionally. So what if you have a casserole dinner on the table – it is full of empty calories! It isn't going to keep you going through the night till breakfast. You'll be raiding the refrigerator, eating junk food, gaining weight, but not supporting your long-term health. Just because it tastes good, and it reduces time slaving away in the kitchen, doesn't mean it's good for you! Don't swallow it! Don't put your hard earned dollars into food that isn't nourishing you for the long term. Look what has happened to our society since the good old days of Mom in the kitchen. Introduce cream of mushroom soup and boom, 50 years later we have the highest level of obesity in recorded history!

Go back to the old ways – this pseudo-food is killing us! Forget how enticing the food looks with Campbell's soup mixed in, rediscover real nourishment and sustenance from honest whole food.

Sloan and Gavin have argued that the important pension questions are only partly about ethical and effective management of resources – human as well as financial. The essential questions are also about whether employers can and should responsibly provide retirement income for their employees. Not every parent or every company has the ability or economic means to provide ongoing sustenance forever. No matter how many jars of canned tomatoes or frozen pesto have been set aside, it is possible that the children will outlive the parental promises to care for them always.

The family meal metaphor doesn't easily stretch to explain corporate executives raiding pension plans to line their own pockets. This conduct, as Werhane points out, is morally reprehensible and violates firm obligations. It would be a little bit like kids coming home expectantly to dinner, only to find an empty table, an empty refrigerator, and an empty oven, while Mom and Dad have gone out to the fanciest restaurant in town.

Contemporary Failings

All three authors recognize the necessity of creating pension plans that take into account market volatility, employee mobility, longer life expectancies, as well as re-establishing the ability of employees to plan for retirement with reasonable and reliable expectations. But they have very different ideas about how to achieve these goals.

Sloan and Gavin suggest that given the difficulties of sustaining financial commitments over 30 or 40 years, as well as accurately calculating remaining years of life, the more responsible action would be to leave behind the old style defined benefit plan, along with its accompanying false hopes and expectations, for a type of plan that reflects the contemporary needs for portability and shared risk.

In contrast, Bennett argues that the movement away from defined benefit plans is a major abdication of employer responsibility. In fact, the defined contribution retirement plan has no claim of being a security in our common understanding of that term. Such plans are part and parcel of a bigger movement among corporations to leave a few cans of food on the kitchen counter with a note that says "Warm these up for dinner." It's been all downhill since the cream of mushroom soup invaded Turkey Tetrazzini.

In the time of King Amel-Marduk of Babylon when he freed the captive King of Judah and gave him a pension for the rest of his life, you can bet that it wasn't canned food. Even the ancient Greeks gave real olives, real bread and wine to disabled paupers to sustain them, not canned beef hash. The contemporary trend toward neglect of the retirement needs of our working labor force is perhaps unprecedented in recent centuries. With the decline of union

membership and the negotiating power of labor, corporations have been able to reduce their contributions as well as their promises to establish retirement systems. The post-World War II commitment to provide for an aging population has been abandoned, according to Bennett, as we opt for a radical individualism – every man and woman for him or herself, as we head into the long home stretch of retirement. As employers have reduced benefits of their employees, corporate CEOs and other high level managers have grown fat on foie gras.

Werhane shares much of Bennett's dislike of the current menu. But rather than pining over meals gone by, Werhane suggests that we should recognize the shortfalls of the present offerings and move on to another system in which we have transparency, control, and mobility. She looks to the model of TIAA-CREF as worthy of emulation. In these plans, the retirement savings earned with one employer move with the employee when the employee changes jobs. Werhane's insights about the social value of professionalization are innovative and promote the empowerment of middle- and lower-income workers. Professional associations could potentially replace the old unions and establish both standards and pride in work quality. Such a perspective would benefit both employees and employers and might serve to set right the balance of power which has tipped so far toward the employers.

While Sloan and Gavin explain what is wrong with traditional defined benefit plans, and Bennett rails against the shortcomings of defined contribution plans, neither goes far in solving the remaining problems. Werhane's proposals contribute an initial set of criteria for a new approach. I'd like to build on these criteria to propose a few dramatic alterations to existing retirement systems, acknowledging the flaws in both defined benefit and defined contribution plans.

Today we need a retirement security plan that is portable, transparent, trustworthy, sustainable, and sustaining for the decades ahead, one that addresses the needs of lower- and middle-income wage earners, as well as one that safeguards the savings of higher-income employees. The Pension Benefits Guarantee Corporation (PBGC), the default guarantor of corporate pension plans, is currently facing a shortfall of over $23 billion as it struggles to recreate pensions for employees of bankrupt airlines, textile, steel, and automotive companies, among others, who have lost out in the global competition with foreign companies not burdened by massive pension liabilities (Walsh, 2005). The PBGC gives no sign of becoming a long-term solution for our systemic pension problems, or the retirement needs of individuals.

The PBGC has become the soup kitchen of pensions. It provides the minimum, not the best, not what you thought you had coming, but a large pot of old vegetable soup, watered down to make it go around between the millions who have shown up unexpectedly at the door, hungry and angry. It won't last long

if the kitchen continues to accept all comers. The ingredients are supplied by meager government contributions and token corporate contributions over the years. A much greater level of support is needed, but where to find it remains an unanswered question.

Lessons from Chile

A recent study of the effects of a change in the Chilean social security system 25 years ago offers a remarkable potential solution to our retirement quandary (James & Edwards, 2005). In the late 1970s and early 1980s Chile faced many of the retirement-related problems that America is facing now: a traditional pension system funded by rising taxes on younger wage earners, drawn down by older workers retiring increasingly earlier (Tierney, 2005). Like the U.S. social security system, there were economic disincentives for older workers to continue working once they began to draw their pension, and incentives to withdraw their pension accounts earlier, since the incremental benefits of continuing to work were minimal at best. Further, pensions were not automatically indexed for the run-away inflation, thus diminishing the long-term value of the individual and collective benefit. This was a defined benefit system that offered diminishing sustenance to retirees and was supported only by burdensome taxes on younger workers.

A radically changed defined contribution system was adopted in 1981, which includes the following provisions:

1. Payroll pension taxes were cut from 33% to 13%.
2. Pension contributions accumulate in individual accounts, invested in a pension fund which has earned a market return averaging greater than 10% per year during the first 20 years.
3. Account accumulations and annuities are maintained in a price-indexed security, so as to keep pace with inflation.
4. On reaching retirement age (65) workers may begin withdrawing regardless of the amount in their accounts, but there are restrictions on early withdrawal.
5. Pensioners can continue to work and are exempt from pension payroll tax.
6. On retirement, accumulated accounts are turned into pensions in which incremental contributions yield commensurate benefits.

James & Edwards (2005, p. 3)

One outcome of this system change is that people are working longer, given the opportunity to stay active and continue earning, without harming their pension calculation or being burdened by continuing payroll taxes. Throughout their working lives, employees contribute to their own retirement

accounts, much like Werhane's model, the TIAA-CREF funds. The investment management of these is handled by knowledgeable, reliable experts, so the risk is minimized, although it is not shouldered by the employer. These structural changes lead to a much tighter link between contributions and accumulations. Since the accumulated funds are in the name of the individual worker, they are entirely portable and transparent.

James and Edwards used household survey data from 1960 to 2002 in Chile to assess the continued labor force participation of older workers, and the average age at which pensions are withdrawn. Their findings indicate strong effects of the new system on the choice of older workers to continue to work, due to the removal of pension payroll tax for pensioners, and a rise in the average age for pension withdrawal resulting from restricted access for early withdrawal.

This system, while going farther toward the radical individualism bemoaned by Bennett, offers solutions to the needs for increased portability, individual control, trust, increased security, and increased provisions for longer lives. However, an economic incentive that encourages retirees to continue working if they are able flies in the face of the early retirement entitlement mentality that reigns in America. Such a system may be pie in the sky: a lovely vision, yet ultimately unreachable. It is ironic to be living in an economy passionately dedicated to capitalism and have our retirement system hamstrung with a collectivist social security philosophy.

But contemplate the soup kitchen alternative of the PBGC, and the bloated obesity taking over our nation as the masses attempt to sustain themselves with oversized portions of nutritionally deficient wannabe foods. Living independently and feeding ourselves with sustaining whole foods that we have raised in our own gardens are far better than being spoon fed the remnants of a watered-down collective pot.

A system like Chile's could offer a much needed incentive for economic growth with continued work force participation, and a reduced burden on tax payers to fund social security for the elderly as well as an overwhelmed and failing pension bailout plan. Individual creativity and sustained activity for retirees would complement long-term control of retirement savings. As older people choose more interesting work in retirement they would also gain the satisfaction of providing for themselves instead of depending on their working children to feed them, either at the dinner table or through heavy taxes.

While I share Bennett's interest in a society supported by mutual obligation and sustaining care, the defined benefit pension plans have failed to provide a sustainable system for our society. Rather than trying to rewind the economic and social clock to a period of paternalistic organizations and powerful labor unions doing battle for their members, it makes more sense to move forward to enable greater individual control of earned assets. A caring government

could create policies which incentivize creativity, mental and physical health, community contributions, and longer-term activity instead of longer-term retirement. For sustenance, remember to set aside land in every town nationwide for community cooperative gardens. Regular meals of freshly made ratatouille from garden vegetables might just reduce public health costs while also providing the gardeners with a life rich in nurturing.

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Part II

Pension Plan Changes

One of the most controversial and problematic issues on the changing scene of corporate retirement plans concerns various changes in funding, structure, and organization of these plans, and these changes become particularly problematic when they are invoked unilaterally. As the chapters in this section discuss, these unilateral changes can occur in a variety of ways.

As a background to consideration of pension plan changes, Eugene Heath maintains that we ought to keep an eye toward financial markets and individual responsibility. In "Markets, Promises, and Responsibility: Reconsidering Pensions and Ethics," Heath says, first of all, that companies must keep the promises they made to fund pensions, and that these promises must be evaluated with respect to the conditions in place when they made them and to the legal context within which they were made. Heath also argues that the societal good of encouraging individual personal responsibility gives a strong reason for preferring defined-contribution over defined-benefit plans. Amplifying the theme of individual responsibility, Heath says that "At best, there is no reason to think that the government should be insuring pensions in the first place." A world of insured pensions provides both firms and employees with excuses to evade their respective responsibilities. As Heath concludes: "Any structural reform of the PBGC (Pension Benefit Guaranty Corporation), including its privatization, should take into account whether or not the effects will hinder or strengthen market incentives for responsibility. Anything else would be irresponsible."

In their article, "Not How Much But How: The Ethics of Cash Balance Pension Conversions," Michael Johnson-Cramer and Robert Phillips focus on the conversion of pension plans to an alternative pension structure – the "cash balance pension plan." This particular issue provides a springboard to a fuller consideration of the range of issues involved in unilateral changes in the terms of pension plans. Abstracting from the particulars that Johnson-Cramer and Phillips consider, a cash balance plan is a defined-benefit plan in which individuals have particular accounts identified with them. Most saliently, the conversion from a traditional defined-benefit plan changes the accrual pattern in a way that disadvantages older, longer-term workers and advantages younger shorter-term workers. Critics of these cash balance plans find them to be unfair, discriminatory, and opportunistic, the basic charge being that such

conversions are unjust from the point of view of distributive justice. Johnson-Cramer and Phillips find those charges to be overstated, but they emphasize that important issues of procedural justice are at stake in the manner in which such conversions are introduced and implemented.

Duane Windsor considers changes in retirement plans more generally in his "Ethics of Corporate Retirement Program Changes." Windsor predicates his argument on two empirical beliefs: that in making such changes that company executives behave amorally or under a strictly economic perspective and that the public interest requires that firms should go beyond mere legal compliance in their pension plan behavior. Windsor considers three approaches to the company conduct he regards as amoral and opportunistic: normative, descriptive, and instrumental stakeholder theory. On Windsor's view, each argues for behavior on the part of firms that diverges from merely economically driven considerations.

Jeffery Smith considers and evaluates the first three chapters of this section in his contribution "Reflections on Markets, Retirement and Corporate Responsibility." Smith sees strong similarities between health care and retirement security as two social goods that are vital to a society that functions well, so he is basically concerned to step back from specific issues to consider how a society should be structured to achieve such a social good. Within this framework Smith considers some of the social changes that make the role of pensions and retirement security a complex issue in our society. He goes on to address Heath's concerns regarding individual responsibility, but Smith is also concerned to consider the need for coordination and oversight in retirement planning. On Smith's analysis, some of these considerations argue against free-market solutions. For Smith, the overarching social problem is to design a system with the right mix of regulation and individual responsibility that leads to the best societal outcome.

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Markets, Promises, and Responsibility: Reconsidering Pensions and Ethics

Eugene Heath

In his poem, "Little Gidding," the last of his *Four Quartets,* T.S. Eliot writes of his encounter, in the early dawn, with a "compound ghost" who intones, "Let me disclose the gifts reserved for age/To set a crown upon your lifetime's effort."[1] In subsequent lines the ghost reveals that the gifts that "crown ... [a] lifetime's effort" are, in fact, weaknesses and infirmities – both moral and physical – that accrue with age. The ghost's words remind us of the vulnerabilities of aging. Because of these vulnerabilities, most of the elderly must diminish their endeavors to provide for themselves. Yet neither the benefit of a leisured retirement nor the essential goods of food, housing, and clothing are available without someone's foresight, planning, and effort. These goods are the products of scarce resources, not to mention time, effort, and skill. The productivity and prosperity that allow for retirement draw from the knowledge and activities of individuals interacting within markets. And it is within such markets that individuals must plan for retirement.

Over the past 50 years, the private corporate pension has been one of the most important instruments for retirement investing. Yet during the past decade, as increasing numbers of corporations have encountered economic difficulties, these pensions have sometimes been terminated or underfunded. Most of the pension plans at risk are defined-benefit plans, many of which were initiated as a result of collective bargaining between unions and management. That such plans are so often foundering raises a host of political, economic, and moral questions. In this chapter, the discussion pivots around the moral question of whether or how private corporate pensions support the value of individual responsibility. Responsibility is a character trait that is not only crucial to the functioning of markets but worth encouraging for its own sake.

In the first section of this chapter, I contend that business ethicists ought to be wary about issuing moral recommendations about some features of the operation of the market, including the specifics of pensions. Nonetheless, it might be

[1] Part II, stanza 4 (1963). *Four Quartets,* in *Collected Poems: 1909–1962* (p. 204). New York: Harcourt Brace & Company.

argued that there is one clear ethical responsibility that all companies have with regard to their employees' pensions: to keep the promise to fund these pensions. In the second section, I suggest that any such promises should be evaluated with an eye to both (i) the conditional nature of promises and (ii) the legal context in which companies instituted their pensions. In the third section, I turn to a consideration of two kinds of benefit plans, suggesting that there is a moral consideration, that of individual responsibility, relevant to opting for one (the defined-contribution plan) over the other (the defined-benefit plan). Finally, in the fourth section, I offer brief suggestions as to how the notion of responsibility should also affect a consideration of the structure (or restructuring) of the Pension Benefit Guaranty Corporation (PBGC).

The Limits of Ethical Analysis

The business ethicist seeks to elucidate and evaluate the framework, operations, or effects of markets. In considering particular laws, specific business practices, or typical consequences of markets, the ethicist must call upon criteria that are normative rather than economic. Nonetheless, no normative exploration has relevance or force unless it takes account of pertinent facts or circumstances. In business ethics, a normative consideration of some particular law or policy, practice or judgment, consequence or effect must rest on understanding the overall structures and features of business and markets, as well as the particular circumstances surrounding the law, policy, or practice. (Of course, such an understanding, in its appeal to either principles of economics or of management, need not be incontestable. Nor should one expect the relevant normative ideals or principles to be without controversy.) The discussion below begins with an account of markets, followed by the briefest history of the emergence of a particular market practice, private pensions. With this understanding of markets, it is argued that the business ethicist may, justifiably, have little to say about whether or not a pension should be instituted at all.

The private corporate pension is not essential to all markets but is a contingent feature of *some* markets. That it is a feature of some markets suggests that there are specific circumstances – legal, social, or historical – in which such pensions emerge. The products and services that emerge in markets reflect adjustments of market participants to a variety of circumstances. The legal framework sets forth, for all participants (whether individuals or firms and organizations), a set of permissions, requirements, and prohibitions. The events, practices, and activities of markets and businesses arise and occur within this framework. Laws and regulations – including those of property, contract, and exchange – affect the patterns and practices of markets by prohibiting certain options, requiring specific actions, or by raising the costs of performing one act rather than another. Such laws provide conditions in

which individuals (and organizations and firms) may peacefully and voluntarily interact and respond to opportunities and incentives. That a particular law, regulation, or policy is an established part of this framework, does not tell us whether it is just, fair, or efficient. In fact, apart from any question of legal or constitutional validity, the moral justification of such laws may be grounded in terms of rights, spheres of liberty, or utility.

Although markets require a legal framework, other circumstances – biological, geographical, social, and historical – affect the economic order. Some of these are sheer factual circumstances, or beliefs about such circumstances,[2] including, for example, the availability of natural resources, proximity to mountains or seas, or medical and biological facts regarding life expectancies. Other facts may reflect subjective preferences: Is silver more expensive than copper? Do consumers prefer rice to potatoes? In addition to these facts, and beliefs about them, there are the characteristics – moral, social, and psychological – of the market participants. Moral, social, and psychological conditions and qualities affect the operation of markets and commerce.[3] These factors not only help determine what is produced and how, but they are the basis for the actions, habits, and attitudes that affect the long-term success of markets. Norms and expectations of trust, as well standards of responsibility, reliability, honesty, civility, creativity, initiative, self-discipline, and self-denial are crucial to the success of markets and businesses.

Given this account of the features of markets, it is important to recall how market practices emerge and survive. In conditions of scarcity, and with limits on both knowledge and benevolence, prices serve as incentives or impediments to action. Profits function, as do prices, to direct individuals to activities and exchanges that will increase wealth. Exchange permits the parties to realize mutual benefits and to reap gains from the division of labor. As productivity increases – affected by a variety of conditions, including skills, capital, knowledge, and the legal and regulatory environment – incomes rise. As this process of production and exchange proceeds, innovations in products, services, and modes of production occur. Some practices or products decline as others emerge. This is the expected general effect of market processes and competition.[4] The variety of goods and services, the changes in production techniques

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[2] It might be argued that, strictly speaking, it is our *beliefs* about circumstances, and not the bare circumstances, that affect the economic and social order.

[3] See, for example, Deepak Lal (1998). *Unintended Consequences: The Impact of Factor Endowments, Culture, and Politics on Long Run Economic Performance.* Cambridge: MIT Press; Harrison, L. E., & Huntington, S. P. (Eds.) (2000). *Culture Matters: How Values Shape Human Progress.* New York: Basic Books.

[4] This account is not meant to be an exhaustive schema of the structure of markets or of the conditions of exchange. For example, transaction costs may affect exchanges. The degree to which benevolence is limited remains, clearly, an open question.

and modes of organization, reflect continual adjustments of individuals to the actions of each other and to their overall environment. Except to the initiating individual or firm, these adjustments cannot be easily known prior to their emergence. Indeed, the initiation of a change or innovation reflects, in a variety of instances, a conjecture as to whether a product will succeed. In many ways, therefore, until individuals interact we do not know what the specific outcome of their decisions will be. It may be possible to predict some general kinds of market outcomes, perhaps based on precedent, but one should not assume too much.[5] Most certainly, one should not assume that one's own preferred outcome is the appropriate market outcome.

Any discussion of pensions should proceed with a consideration of these features of markets. Private pensions are a particular market practice that began to emerge in the early part of the 20th century. In 1921 the Revenue Act encouraged the formation of private pensions by exempting from the income tax both employer contributions and the "income of pension and profit sharing trusts."[6] The exemption of employer contributions, but not those of employees, gave an incentive to create defined-benefit plans paid for by the employer. Much of the early coverage occurred within large corporations. Nonetheless, in the first quarter of the 20th century almost none of these plans contained any "contractual obligation for the future maintenance of benefit promises or payments."[7]

After the Second World War there was a dramatic growth in private pensions. This growth has occurred concomitantly with the decline in the number of elderly persons who live with their children.[8] Although various factors contributed to the growth in pensions,[9] two great complementary catalysts

[5] If a product or a production technique is protected by either law or regulation, then a prediction of market outcomes becomes decidedly easier! However, where products or techniques are subject to the varying preferences of consumers, it is not as easy to predict which product or mode of production will prevail.

[6] Schulz, J. H. (2001). *The Economics of Aging* (7th edition, p. 243). Westport, Connecticut: Auburn House.

[7] Greenough, W. C., & King, F. P. (1976). *Pension Plans and Public Policy* (p. 34). New York: Columbia University Press. The source of their claim, as noted in footnote 20 of p. 285, is Latimer, M. W. (1932). *Industrial Pension Systems in the United States and Canada* (Vol. 2, p. 707). New York: Industrial Relations Counselors.

[8] Kotlikoff, L. J., & Smith, D. E. (1983). *Pensions in the American Economy* (p. 1). Chicago, IL: University of Chicago Press. It is not obvious that the growth of pensions, whether private or state, is an *effect* of a decline in family support for the elderly. The causal relation may be the reverse, or may involve a more complex interaction between the increasing role of government and the decline of voluntary and familial modes of support. On the displacement of the social by the political, see the classic sociological study by Nisbet, R. (1975). *The Twilight of Authority*. New York: Oxford University Press, especially Chapter 5.

[9] Some of these are noted in Schulz, *The Economics of Aging* (p. 243).

were federal action and union demands. By the decade of the 1940s, law and regulatory policies had encouraged the formation of unions and sanctioned collective bargaining, including bargaining over benefits. Although there has been nothing in the law that obligates an employer to establish a pension plan, some conditions may render their emergence more propitious. At the very least, there are two noteworthy conditions that seem to attach themselves to pensions, and to defined-benefit pensions, in particular: "union status and the size of the employing firm."[10] It would be worth investigating more carefully how these features are relevant to private pensions.[11] For the purposes of this current discussion, it is sufficient to show that private pensions are particular practices that have arisen under some historical and political circumstances.

Even discounting the way in which, say, laws governing unions may affect market decisions, there are complexities that, though perhaps not unique to pensions, are relevant to ethical deliberation. These are the variety of contingencies that must be taken into account in determining whether to institute a pension plan (a form of deferred, rather than current, compensation) or what sort of pension should be instituted. These contingencies reflect the beliefs and preferences of market agents. Thus, setting aside the conceptual complexities that arise at a theoretical level of analysis (e.g., what counts as "retirement"? how should a corporation calculate or measure its future liabilities, whether accrued or projected?[12]), retirement planning presents a complex of facts and possibilities that both a firm and an employee must consider before deciding whether to institute a pension plan. For example, a firm's choice to establish a pension involves determining what package of wage and pension benefits is marketable to employees, what sort of protections and provisions are included in a particular plan, which method of financing is best, how high the administrative costs will be, and so on. Employers may need to experiment in order to find an appropriate mix attractive to the worker and compatible with company goals. Of course, further complexities await the pension fund manager: What will the rate of inflation be? How will inflation affect differing classes of assets? How will government actions alter pension law? How will the fortunes of the company affect pensions?

For the employee, there are various contingencies to consider: Where will I live when I retire or with whom? Will I want to work? Will I be able to work?

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[10] Ibid., p. 245 (original italics omitted).

[11] "One explanation for defined-benefit provisions, for example, has nothing to do with worker incentives; it associates the original design of defined-benefit plans with unions . . . By adopting defined-benefit rather than defined-contribution plans, unions insured older union members attractive pensions in the near future." Kotlikoff, & Smith (1983). *Pensions in the American Economy*, p. 18.

[12] Ibid., p. 11.

How long will I live? How much money will I make before I retire? How much income will I need? How will administrative costs affect my pension benefits? How much will the economy grow and how will it affect my assets?[13] As James Schulz concludes, "There is no doubt that the personal decision-making process involved in preparation for retirement is a very complex one."[14] Of course, since most private pension plans are compulsory (if one works for this company, then one must participate in this plan),[15] this removes, from the employee, some of the complexities of decision. However, the overall complexity remains, for the information relevant to instituting pensions is not only mutable but involves elements that are ineliminably subjective, such as personal preferences and individual assessments of risk and uncertainty.

Complexity confronts both the firm and the individual employee, and there may be no simple answer to the question of whether a pension plan should be established, or of what sort. The answer may justifiably be left up to the experimentation inherent in market interaction. In many instances, whether a particular product, or production technique, should be utilized may be determined best by market decision-making rather than ethical theorizing. Noting the complexities involved, and given that ethical analysis requires knowledge of the relevant facts and circumstances, it seems doubtful that there is any general ethical principle that entails, for all markets (even all developed markets), that a business, firm, or corporation, whether small or large, *ought,* as a simple moral duty, to provide pensions to its employees. Without the testimony of the market, it is not obvious what sort of pension practices ought to emerge, if any. It is not at all clear that grounds exist on which any business ethicist could argue that a firm *ought* to include, as part of its compensation to employees, a benefit that is deferred until retirement. Nor is it obvious that a company that does maintain a pension plan *ought,* as a simple moral duty, to provide a certain kind or type of pension. One knows this no more than one knows that a firm *ought*, as part of its benefit package, to provide 2- or 3-week holidays, or that a firm *ought*, as a moral duty, to provide hot cooked meals for employees (and if so, whether these meals should, as a moral duty, include a side salad!). If one accepts the basic legal and moral underpinnings of markets, then provided that contracts are honored and that individuals are treated respectfully and honestly, there may exist a number of decisions that the business ethicist should leave to the processes of bargaining and market interaction. No doubt some will reject this conclusion. They will think it obvious that a firm ought to provide pension coverage. But those who do so must consider

[13] See for example, Chapter 3, Retirement planning in Schulz, *The Economics of Aging* (pp. 99–130).
[14] Ibid., p. 100.
[15] Ibid., p. 110.

whether they have invoked a moral principle sufficient to establish the obligation or whether they have assumed as fact the very sort of information, about company and employee preferences, that is variable and not easily discerned.

That the business ethicist may not be able to appeal to moral principle to mount an argument for the establishment of pensions does not entail some sort of amoral neutrality. Nor, as shall be seen in the third section, are moral considerations altogether irrelevant. Markets are already moral arenas and the decisions that market participants make are typically embedded within prior moral frameworks and traditions. Nonetheless, so long as constraints on exchange and information are observed, business ethics must leave some decisions up to the market. If a business ethicist suggests that all market decisions may be determined by ethical argument, then the business ethicist is no longer an ethicist of *business.* To understand business as a practice of exchange presumes that one does not know the precise outcomes of most such exchanges. As F. A. Hayek suggests, "*wherever* the use of competition can be rationally justified, it is on the ground that we do *not* know in advance the facts that determine the actions of competitors."[16] The business ethicist may have quite a bit to say about the underlying framework of exchange (laws, regulations, business codes) and may offer moral arguments about what sorts of things should not be exchanged, or exchanged only under some circumscribed conditions. However, precisely because markets reflect permissions, and not just requirements and prohibitions, it follows that individual decisions will differ and change. The very contingencies that one must take into account for retirement – for example, how much money will I need at retirement? How much income do I need *now*? What rate of interest must I assume if I am to acquire this amount? and so on – are dependent on dynamically changing features of the economic and political landscape. For that reason, and because of individual preference, whether to institute a private pension (and of what type) may properly be left up to the discretion of individuals and firms. Does that mean that there is nothing for the business ethicist to say about private pensions?

Promises, Promises

Perhaps there is one very obvious moral recommendation. If a corporation has instituted a defined-benefit pension for its employees,[17] then, it might be maintained, that the corporation has made a *promise* that ought to be kept. Regardless of whether a pension *should* be instituted in, say, Corporation C, if

[16] Competition as a discovery procedure. In *New Studies in Philosophy, Politics, Economics and the History of Ideas* (1978, p. 179). Chicago, IL: University of Chicago Press (italics original).

[17] In this section, the discussion refers only to defined-benefits pensions.

one has been instituted, then there is a clear moral implication: Corporation C should fund that pension, thereby ensuring that it can fulfill its promise to employees. This point has particular relevance in light of the number of corporations that, recently, have either not funded or severely underfunded their pensions.

This point might be strengthened if one considers the perspective of the employee of Corporation C. An employee labors for Corporation C several years (if not a lifetime) and in return receives remuneration in the form of a salary and the deferred compensation of retirement benefits. The employee's labor, in other words, is put forth on the condition that he receives a salary and, at the appropriate age, a specified retirement benefit. Given that Corporation C has utilized the labor of this person in exchange for this total package of compensation, then surely Corporation C has an obligation to recompense the employee as promised. If the pension is part of the compensation, then the underfunding of that pension, or its termination, would break a promise.

If a pension has been contracted between management and labor, there does seem to be a prima facie responsibility for management to maintain the promised pension (and to generate the funds to meet that obligation). Without doubt, many business ethicists recognize this duty to employees, as do some executives.[18] Yet a prima facie claim may be overridden. And in the case of pension contracts, contingences may exist that either override these contracts or, in some instances, weaken their obligatory force. In considering these contingencies, one may discover that the moral question regarding pensions is murkier than sometimes appears.

Few promises are unconditional and most presume implicit assumptions that allow for overriding the promise. This is certainly true of W.D. Ross' important defense of promise-keeping. A prima facie (and common sense) duty, promise-keeping may be overridden only in "the exceptional cases in which the consequences of fulfilling a promise ... would be so disastrous to others that we judge it right not to do so."[19] In the case of a corporation, economic exigencies may arise in which the funding of a pension will either bring on or hasten disaster. In such circumstances, a corporation may, morally, decrease its pension funding or cease to fund its pension. The details will of course differ from one case to the next; without doubt, there may be room for debate as to the degree to which the funding of a pension may hasten the

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[18] Ross, W. L. an investor, who purchased bankrupt steel manufacturers, including Bethlehem Steel, expressed his concern about the steelworkers' potential loss of pension benefits, stating, "[w]e felt a moral obligation to those workers, even though we had no legal obligation." Walsh, M. W. (2005). Whoops! There goes another pension plan. *New York Times*, September 18, Section 3, 9.

[19] *The Right and the Good* (1930, p. 18). Oxford: Clarendon Press.

demise of the corporation. Admitting these points does not, however, debar the more general conclusion.

In a different guise, the conditional nature of promises was also suggested by one of the first business ethicists, Daniel Defoe. He points out how all promises, including those of the "tradesman" are conditional.[20] For Defoe, a promise illustrates an instance of the more general dictum that "ought implies can": One's obligation to perform some action presupposes that one can perform that action. Defoe contends that a businessman may be allotted a certain "license" in the promising of money. Although Defoe steadfastly maintains that, "[t]o break a solemn promise is a very bad thing," the promise itself is undertaken "with a contingent dependence upon the circumstances of trade."[21] Defoe offers the case of a tradesman who promises to pay a wholesaler for goods. Such a promise, he suggests, is dependent on the tradesman (the promisor) receiving money owed to him or securing sufficient revenue through trade. When these conditions are not met, a promise may be broken. A promise may not be broken if one makes no effort to secure the funds to pay the amount promised; rather, it is precisely when one's efforts meet with unforeseen circumstances that one may break one's promise, but doing so is still "a very bad thing." To do so, one may surmise, should generate moral regret, if not a duty to compensate.

Thus, it is plausible to suggest that if business conditions imperil the survival of the company, then the firm may diminish its contributions to its pension fund, and, if conditions warrant, terminate the pension. That a promise was made and that the pension was understood to be part of the compensation remains true, but it is also true that one of the circumstances of receiving this form of compensation was that the business remained a viable enterprise. The pension benefit is, after all, a *deferred* compensation. Among the risks inherent to the form of time preference exhibited by the deferring of compensation is that the benefit may not be available when one wants or expects it. Of course, nothing stated so far addresses the issue of an underfunding that derives not from an unforeseen contingency but from, say, a misappropriation, such as diverting pension contributions to other expenses. If the diversion of these contributions is not related to the survival of the firm, then it may constitute a clear breach of trust distinct from the sort of scenario illuminated by Defoe.

The assertion of a prima facie duty to maintain a promise suggests a second, and more controversial, issue. Just as a promise retains its obligatory force under certain circumstances, so are there conditions required at the very initiation of a promise. The very absence of these conditions may vitiate the status

[20] Defoe (1970). *The Complete English Tradesman* (Vol. 1, pp. 183–184). New York: Burt Franklin.

[21] Ibid., p. 181.

of the promise. The act of promising presupposes that the party undertaking the promise is not only rational and aware of the consequences of the promise but is also acting voluntarily. Since any genuine agreement or contract rests on conditions of rationality, knowledge, and freedom from coercion, so does the contract that establishes a corporate pension. (After all, it is that contract that entails, on the part of the firm, the duty to contribute to the pension fund.) However, pension agreements have been undertaken in contexts that are not wholly voluntary. Such agreements have typically emerged out of collective bargaining between unions and management, and in many instances it cannot be assumed that the bargaining has been undertaken freely and voluntarily. Where this is a fact, as it is in some cases, the prima facie obligation may be reexamined. The moral issues raised by such instances are rather complicated, but they must be broached even if a definitive answer is not immediately forthcoming.

To understand the conditions under which collective bargaining has occurred, it is important to recall some of the historical context.[22] In the 1920s and 1930s many companies instituted benefits and pensions, but these existed alongside rules prohibiting workers from joining a union.[23] Following the Railway Labor Act of 1926, guaranteeing workers a right to choose their union representatives, the Norris–LaGuardia Anti-Injunction Act (1932) sought to remedy the encumbrances on unions by narrowing the means of issuing injunctions. The great efflorescence of industrial unionism and collective bargaining occurs in the 1930s and it was during this decade that unionism came into its own.[24] One illustration of this lies in the amendments to the Railway Act of 1934, forbidding employers to issue so-called "yellow-dog" contracts according to which employees would agree not to form a union. With the institution of the National Labor Relations Board, via the Wagner Act of 1935, there was a clear articulation of rights to organize, strike, and picket, and an increasing legitimization of collective bargaining.[25] In particular, management was *required* to bargain with the union representing its employees (just as labor unions were not allowed to refuse to bargain with management).[26]

[22] For a summary account, see Sass, S. (1989). Pension bargains: the heyday of US collectively bargained pension arrangements. In P. Johnson, C. Conrad, & D. Thomas (Eds.), *Workers versus Pensioners: Intergenerational Justice in an Ageing World* (pp. 92–112). Manchester: Manchester University Press.

[23] Of these pensions Keller reports, "But their number was limited, and welfare capitalism never escaped the (well-merited) suspicion of organized labor that its major purpose was to avoid unionization of the work force." Keller, M. (1990). *Regulating a New Economy: Public Policy and Economic Change in America, 1900–1933* (p. 140). Cambridge: Harvard University Press.

[24] Ibid., p. 117.

[25] Ibid., p. 145.

[26] See Section 8.a of the National Labor Relations Act.

In 1945, when the coal companies refused the demands of the United Mine Workers for a defined-benefit plan, a strike ensued. Only after President Truman intervened, in 1947, was an agreement reached between the United Mine Workers and the coal companies "establish[ing] a new standard for union expectations concerning benefit levels and administration."[27] In 1946 the United Auto Workers, having first reached a tentative agreement with Ford, soon found that Ford did not, in fact, want to negotiate over benefits. Then in 1948, the National Labor Relations Board held that pension benefits were within the scope of collective bargaining; once the Supreme Court upheld this decision (in the case of Inland Steel, 1949), management was legally obliged to negotiate with unions over pensions. Until that time, managements had not acquiesced in bargaining over benefits.[28]

Given that management not only must recognize a union but must also bargain with that union, a crucial question arises: Are collective bargaining agreements free and voluntary agreements? It is not unreasonable to ask whether the law, especially with the decision of 1949 that required bargaining over benefits, has served effectively to violate freedom of speech. In moral terms, to prohibit a party from *refusing* to speak requires that the party speak. It is not at all clear how such a requirement to speak is morally distinct from prohibiting someone from speaking. The relevant right, in this case, need not be construed as a constitutional right but only as a moral right by which one is permitted to speak or not to speak. That one party must bargain in a certain manner, to bargain "in good faith," effectively denies that party the right to withhold speech – the right not to bargain.[29] Of course, one may argue that there are reasons of public interest for overriding this moral right, but such an argument must be made and presumably the burden of proof must be on those who would force one to speak under pain of law.

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[27] Ghilarducci, T. (1992). *Labor's Capital: The Economics and Politics of Private Pensions* (p. 38). Cambridge: MIT Press.

[28] Ibid., p. 38. To this day, many of the underfunded or terminated pensions cover union workers. See Table 4.4 in Weaver, C. Government guarantees of private pension benefits: current problems and market-based solutions. In S. J. Schieber, & J. B. Shoven (Eds.) (1997). *Public Policy Toward Pensions* (pp. 138–140). Cambridge: MIT Press. The overwhelming majority of the companies that are underfunded are either steel or airlines, include LTV Steel, the United Airlines Pilots, National Steel (Schroeder, M. (2005). Pension agency puts pressure on Congress. *The Wall Street Journal*, January 7, A4).

[29] The phrase "in good faith" is taken directly from Section 8.d, The National Labor Relations Act. This same section states that the obligation to bargain "does not compel either party to agree to a proposal or require the making of a concession." That this is true does not overcome the requirement that one bargain, nor does it dispel the concern that some kinds of bargaining would not be considered "in good faith."

One may also consider whether the negotiating union represented freely consenting parties. This sort of consideration is distinct from that of the right of free speech and points, instead, to whether one party to the negotiations acquired its status as a result of privilege, in particular the monopoly privilege granted by law. And in fact, by the National Labor Relations Act, a union that wins the majority of votes becomes the exclusive bargaining agent for all workers in that company, even those who did not vote for that union or who do not want union representation at all. Thus by a majority vote, one union becomes the monopoly agent for all workers. In speaking for all employees for a company, the union may misrepresent the workers who either did not vote for a union or who did not vote for this union.[30]

To the extent that the negotiations are forced and to the extent that one party to these negotiations acquires its status through non-voluntary means, then so are the results of the negotiations morally suspect. None of this broaches the matter of *legal* obligation. After all, one may disagree with a law but still find an obligation to obey that law.[31] However, doubts regarding the circumstances in which a contract or agreement is secured may, nonetheless, affect the moral obligation to honor that agreement. Even if a company bears the legal obligation to fulfill the terms of a pension agreement, that obligation does not establish the moral status of that contract.

What inferences may be drawn? The first conclusion is that in deliberating over the obligations of corporations to fund their pensions, it is essential to consider the whole picture: Too often ethicists consider only the end of the story ("the company ought to do what it promised") while ignoring altogether how the story began. To ask only about the end and to ignore the beginning is to ignore the complicated moral context in which some burdens, if not real obligations, have arisen. Are there, however, more specific conclusions? Such conclusions are not easy to draw without examining particular cases – individual companies, unions, negotiations, employees, and so on. Nonetheless, some general lines of moral consideration emerge. One must ask whether or not the negotiations occurred precisely because of the laws mandating collective bargaining and whether or not the pension plan would not otherwise have come

[30] It might be argued that the problem of misrepresentation also afflicts democracy more generally. By a majority vote, an elected representative speaks for all constituents, even those who did not vote for that representative. However, there is at least one salient difference between the election of a union to represent all employees and an election of a representative. In a democracy, the election of representatives occurs at a fixed time and the term of office lasts but a short period (e.g., 2 or 6 years). In the case of unions, there are no fixed elections or set periods of representation. (It is possible to have a decertification of a union, but this requires that at least 30% of the employees petition for such. See Section 9.e of The National Labor Relations Act.)

[31] Nor need one broach the issue of whether or not the requirement of collective bargaining ought to be understood to violate a constitutional right to freedom of speech.

into fruition.[32] If the company and the union would each have negotiated voluntarily – even without a law that required bargaining – then the promises encumbered by the company should be kept, at least contingent on economic survivability.

On the other hand, suppose that a pension plan has been instituted precisely because of the duress of the law; that is to say, this plan would not have been brought into existence except for the fact that the law demanded that the company bargain with the union. Suppose, further, that one outcome of bargaining was a direct benefits pension plan. If these assumptions hold, then would this entail that a company does not bear a moral obligation to fund its pension plan? It might be tempting to infer this conclusion. However, a complication arises from the fact that companies themselves are often complicit in the activities of the union. In almost every instance, an employee must join a pension plan as a condition of employment and the pension benefit is marketed to the employee as one element of compensation. To address this complication, two types of cases may be considered.

In the first kind of case, those who are the beneficiaries of the pension plan are the same employees who were members of the union at the time of the initial bargaining agreement. We might also stipulate that these employees were universally in favor of their union and, therefore, that union negotiators were the genuine (and legal) agents of all employees. The corporation C, however, did not want to bargain over benefits and would have preferred not to bargain at all with the union. Without the law mandating bargaining, corporation C would have declined to bargain with the union, the universal agent of the employees. Nonetheless, the bargaining takes place[33] and a defined-benefit

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[32] It might be argued that corporations are eager to fund pensions, for these serve as a means of attracting long-term workers, as well as a means of setting aside those workers whose productivity is below average. This is hardly different, it might be said, from the union that also seeks to hold onto its workers by providing what the average worker wants. It seems clear that the unions assist older workers who are, because of their age, more interested in pensions and retirement benefits. See, Freeman, R. (1985). Unions, pensions, and union pension funds. In D. A. Wise (Ed.), *Pensions, Labor, and Individual Choice* (pp. 89–118). Chicago, IL: National Bureau of Economic Research. More generally, an employer or firm will agree to a union demand for a higher wage, whether in salary or in benefits, only because the employer recognizes that the union will prevent anyone else for working for that employer at a lower wage. Thus, a union makes wages higher for those who remain employed. With a higher wage, employers will, however, demand less labor. Thus, unions may raise wages only by limiting the supply, for example, by erecting some barrier to entry or competition. Some of these implications of the monopolistic functions of unions are discussed in Johnson, H., & Mieszkowski, P. (1970). The effects of unionization on the distribution of income: a general equilibrium approach. *Quarterly Journal of Economics*, *84*, November.

[33] I set aside the further complication of whether the bargaining must be enjoined, say, by court order, or whether it occurs because the executives of company C believe that the law obliges them to bargain with the union.

plan is part of the agreed outcome. The very same individuals present during the original negotiations between union and management remain with the company and no other persons are ever hired. In this (unusual) scenario, it seems clear that C is legally obligated to fund the plan (i.e. C is morally obligated to obey the law). However, given that C was forced to bargain over pension benefits and preferred not to do so, it is not at all clear why the outcome of prescribed bargaining represents a voluntary agreement. In other words, the legal obligation of C has *no* moral foundation.

Consider a second case. This differs from the first only in that the employees covered by the pension plan include persons who were not present from the moment of the original negotiations and subsequent pension contract. Thus, in this second case, some of the employees covered by the pension plan were hired after the plan was originally agreed upon between the union and management. When these new employees were hired they were informed that their remuneration included a deferred pension benefit. In this case, the very fact that corporation C has offered the pension plan as part of its compensation package – remuneration for working at C – not only gives this firm the legal but also the moral obligation to fund the pension program. A failure to fund the pension plan would involve a breach of contract to the new employees. In this second case, even if the birth of the pension plans was morally illegitimate, that does not entail that its continued existence generates no moral obligations.

The structural lines of these considerations are quite general and they may not fit neatly across any specific instance of an actual agreement between company and union. However, these considerations do point out that the simple cry that "companies ought to keep their promises" may not take into account the circumstances in which these "promises" were made. On the other hand, those who plead that companies that were forced to bargain collectively incur no obligations to their employees must be reminded that these same companies have advertised and hired on the basis of these very benefit plans. To have offered a pension but left it insufficiently funded converts what should be a real commitment into a spurious promise.

Kinds of Pensions and the Idea of Responsibility

So far I have argued, in the first section, that there are limits to what may be said about the ethics of instituting a pension. And I have just described how the commitment to fund a pension is subject to moral complications. Nonetheless, are there moral considerations relevant to the evaluation of one type of plan over another? Such considerations may not be sufficient for arguing that such a plan should be instituted, but they are, at the least, relevant

to the overall moral value of the plan. Consider that private pension plans are typically divided into two types: defined-contribution and defined-benefit. Each has its practical advantages. The number of participants in defined-benefit plans has gradually diminished since about 1984, just as the number of participants in defined-contribution plans has steadily risen since 1975.[34] Are there moral considerations for preferring one to the other?

A defined-benefit plan determines a payment by utilizing some specific formula. Benefit payments might be calculated, for example by multiplying a dollar amount by the number of eligible years of service that an employee has worked. An alternative method combines the employee's years of service with earnings over some specific period. Although a defined-benefit plan lacks portability, it establishes a fairly clear determination of future payouts. The employee need not assume much, if any risk, even as the employer is taking on a commitment of many years. The firm must contribute to the pension fund in accordance with minimum funding standards established by ERISA, the Employment Retirement Security Act of 1974.

The defined-contribution plan has been popular with small firms, the defined-benefit plan with larger and unionized firms.[35] Among the advantages of the defined-contribution plan is its ease of administration and the predictability of cost to the firm; in addition, it is easier for workers who move from one job to another to carry their program with them. That said, these plans encumber the employee with a greater risk in that the employee must guide his investments through variable markets and cannot expect a guaranteed payout.

Are there moral considerations relevant to preferring one plan to another? This question could be posed either from the point of view of the firm or from the point of view of the employee. Whichever perspective one adopts, what is striking, as I have suggested above, is the seeming paucity of ethical resources for answering these questions. As noted in the first section, the decision to institute a pension plan is, in many respects, best left to the marketplace itself. That said, in choosing between two main types of pension plans, there is a moral consideration worth examining – responsibility. There is much talk in business ethics of social responsibility, a notion that, as Richard DeGeorge has pointed out, often "includes a grab bag of obligations, some of them moral and some not."[36] However, there is another form of responsibility, that of the individual, that is fundamental and worthy of consideration. One of the more

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[34] See Figure 7.1 in Schulz, *The Economics of Aging* (p. 257).

[35] Kotlikoff and Smith note that, "While the correlation between plan size and firm size is not unity, it appears to be quite large. Small pension plans, most of which are plans of small firms, presumably favor the defined-contribution plan relative to the defined-benefit plan, in part, because of economies in book-keeping." *Pensions in the American Economy*, p. 164.

[36] *Business Ethics* (4th edition, 1990, p. 199). Englewood Cliffs, NJ: Prentice-Hall.

significant attributes of an individual is that the person is "responsible." As Elbert Hubbard put it, "[c]ivilization is one long anxious search for just such individuals. . . . He is wanted in every city, town and village. . . ."[37]

What sort of responsibility is relevant? To talk of responsibility is to refer either to acting responsibly or to being held responsible. To be held responsible is to be expected to act responsibly. However, the opposite implication does not follow. If an individual acts responsibly that does not entail that the person is held responsible. One may act responsibly even though one is not held responsible in that situation. (The person who stays after hours to assist in finalizing the production of some goods for sale may not be held responsible for this assistance, even though such actions are responsible.)

What is it to act responsibly? This sort of responsibility presupposes moral responsibility – whether one is blameworthy or praiseworthy for some act or omission. The morally responsible person possesses the capacity to understand, to reason, and to control his actions. Such an individual is, at the least, able to make decisions and to act in accord with these choices. Yet moral responsibility is but an element of a broader sort of responsibility, perhaps best encapsulated by J. R. Lucas. If I am responsible, he writes, then "I shall think about what I am doing, rather than act thoughtlessly or on impulse, and act for reasons that are faceable rather than ones I should be ashamed to vow."[38] Clearly, this sort of responsibility presupposes moral responsibility and a freedom to act. But it is a responsibility that denotes, as Lucas points out, "a quality of character and mind."[39] Such responsibility is also particularly valuable in a market society. To be responsible is to seek to bring about, voluntarily, an appropriate outcome (either by act or, in some cases perhaps, omission), and to do so with attention, knowledge, and care. The responsible person tends to exhibit conduct appropriate for the circumstances and demonstrates a seriousness of purpose and effort, as well as attentiveness to relevant particulars. It is in this way that the responsible person demonstrates a responsible disposition, a *sense* of responsibility valuable for the individual and for society.

It should not be surprising that responsibility is often accompanied by self-reliance: The person who thinks, attends, and acts for (good) reasons need not be subject to commands and need not appeal (unreasonably) to the guidance of others. Indeed, that responsibility carries with it other praiseworthy traits is an important argument for its encouragement or for putting into place the social and political conditions that support it. Even if one does not take responsibility to be a moral *virtue*, it may nonetheless presuppose a virtue, that of self-control.

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[37] A message to Garcia. In *A Message to Garcia and Other Essays* (1916, pp. 22–23). New York: Thomas Y. Crowell.

[38] *Responsibility* (1993, p. 11). New York: Oxford University Press.

[39] Ibid., p. 11.

The responsible person exhibits good judgment and self-control. But the virtue of self-control connects with trust, a crucial element in the organization of firms and in the conduct of everyday exchanges. For example, the person who is responsible is able to forestall, via self-control, the temptations of momentary impulse or immediate gratification; for this, and other reasons, such a person can be trusted to act with an eye to the long term.

A second argument for responsibility relates to markets and business. The order of a market is constantly changing, both in response to natural circumstance and in response to social changes and alterations of individual preferences. Such complexities demand decentralized decision-making and experimentation. Yet insofar as markets rely on decentralized decision-making, so must they presuppose that participants are responsible. Responsibility is a postulate of the successful operation of business and exchange, but it does not occur automatically. Markets need responsible participants, and we must take care that market structures and cultural expectations reinforce responsibility and provide incentives for its cultivation. If we want the goods of markets, then we should take into account whether certain practices advance or retard the exercise of responsibility. If we agree that each actor in the market is, in general, well-placed to know and act on his own preferences, to act attentively to self and to others, to engage his efforts productively, then the encouragement of responsibility helps to ensure that market participants perform these actions reasonably well.[40]

How does this conception of responsibility relate to pensions? The economic argument that complex contingencies call for decentralized decision-making is bolstered by the ethical consideration that each individual has the responsibility to consider and take care of his own future and that of his family. The point is not merely that social expectations and moral rhetoric should emphasize responsibility. Rather, given decentralized decision-making the individual must care for and attend to the contingencies that arise for self and family, as well as neighbors and friends. Ultimately, however, the value of responsibility is not derived from the market or from some contract but, ultimately, rests on assumptions about human well-being. And if responsibility is a good, it does not entail any sort of radical individualism; it is compatible with the idea of community and interactive reciprocity among and between family members, neighbors, and citizens. Thus, the appeal to responsibility does not require that each retiree must live off his or her own savings, nor does

[40] This does not imply that responsibility is the only relevant moral consideration. Nor should these brief considerations be understood as suggesting that responsibility is nothing but prudence. Responsibility is not incompatible with acting in ways that are broader than mere profit maximization and more extensive than prudence. Some individuals may, and properly, value things other than profit and they may value these responsibly.

it preclude that a responsible retiree may live with children. Responsibility involves reciprocal relations among and between individuals and kin. In fact, the locus of individual responsibility is rarely the individual but the family.[41] To be responsible for the self is in fact to be responsible for others.[42]

Between the defined-benefit and the defined-contribution plan, the latter is more closely supportive of responsibility. In the first place, the defined-benefit plan places the responsibility for one's future in the hands of others (the firm and its pension managers) and requires only that one continue to do what one was doing already: working at the firm. A defined-benefit is typically managed by the firm in order to generate a specified benefit for the employee. The funds for one's retirement are dependent, in a direct way, on the labor of others who work at the firm. On the other hand, the defined-contribution plan requires that the employee exercise some thought and attention to the complex contingencies of his or his family's future, including an assessment of the kinds of risks associated with discretionary features of such plans, including where and when to invest the funds.

A second consideration points to the relation between risk and responsibility. In a defined-benefit plan a worker bears the risk of losing the pension if the plan is terminated, receiving a lesser amount from the government insurance agency, the PBGC. The bearing of this risk is not the same as bearing responsibility, but there is a relation between some risks and responsibility. In a defined-contribution plan, one does not face the risk that the plan may be terminated by the Corporation; however, another sort of risk comes into play, decision-making, and it is connected to responsibility. The decision as to how

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[41] One is reminded of Joseph Schumpeter's admonition regarding the economists' use of "self-interest": "In order to realize what all this means for the efficiency of the capitalist engine of production we need only recall that the family and the family home used to be the typically bourgeois kind of profit motive. Economists have not always given due weight to this fact. When we look more closely at their idea of the self-interest of entrepreneurs and capitalists, we cannot fail to discover that the results it was supposed to produce are really not at all what one would expect from the rational self-interest of the detached individual or the childless couple who no longer look at the world through the windows of a family home. Consciously or unconsciously they analyzed the behavior of a man whose views and motives are shaped by such a home and who means to work and to save primarily for wife and children." *Capitalism, Socialism, and Democracy* (3rd edition, 1942, p. 160). New York: Harper and Brothers (emphases omitted).

[42] One of the difficulties of increasing the welfare functions of the state is that it may diminish the responsibility of the family. The protection of the aged is, rather like the protection of the child, properly the responsibility of the family. Nor should we easily accept the view that prior to the emergence of government retirement programs, the elderly were living in poverty. As Carolyn L. Weaver has argued, in the 1920s of the 5.8 million individuals over 65 years of age, "Most of them live in their own homes, most are self-supporting, and among those who are not, the vast majority are cared for by family members." Support of the Elderly Before the Depression: Individual and Collective Arrangements. *Cato Journal, 7*, Fall 1987, 507. Weaver also notes (p. 510) how poverty is "concentrated among people with few, if any, relatives."

to invest one's future retirement funds involves risk of the sort that stimulates attention, foresight, effort, and self-control. The management of this risk requires that one endeavor to be responsible, thereby supporting traits not otherwise elicited through defined-benefit plans.

It may also be noted, finally, that the defined-contribution plan often requires the employee to make a regular contribution, thereby demanding that the employee become a (somewhat) more active cause in his or her own destiny. One might suggest that this kind of responsibility is a vitiated responsibility, either because it is a condition of one's employment or because the contribution is automated through a payroll deduction. Even so, the "imposition" of this responsibility may have some internalizing effect so that the individual recognizes that each contribution is, nonetheless, subject to his decision and guidance, even if it was a condition of employment or an automated deduction from wages or salary.

How seriously should we weigh these considerations? There is no perspicuous answer to this question. However, that does not mean that the relation of practices and policies to traits of character is not relevant. The goods of virtues, including that of responsibility, are not free-floating items, easily attachable to any sort of practice. Indeed, these goods are, rather like natural resources, *scarce*, and we should seek their conservation. Moreover, these goods are not discrete – they do not travel alone, or in specific acts – but take root in dispositions and character. In so doing, they often bring other goods in their train. Thus, that we encourage one good, responsibility, may have unforeseen effects in strengthening other moral goods. Among these would be self-control, the virtue that, Aristotle rightly held, underlies our ability to be virtuous more generally.

Responsibility and the PBGC

Responsibility may also have relevance to an evaluation of the government's insurance program for defined-benefits. The PBGC is a federal agency, chartered by the Employee Retirement Income Security Act of 1974. The mission of the PBGC is to insure defined-benefit plans (those that are vested), providing guarantees up to certain defined limits. The PBGC exists and functions largely through the collection of required insurance premiums; it receives no government funds or tax revenues.[43] The PBGC acts when a company cannot

[43] The base premium has been $19 per participating individual, with a $9.00 surcharge for every $1,000 of underfunded vested benefits. *Code of Federal Regulations,* Title 29: Labor, Chapter XL, PBGC, §4006.3. As Weaver, C. L. points out, the premium rate is capped at $72 per participating company, so that "companies with the largest unfounded liabilities pay an even lower rate." *Government Guarantees of Private Pension Benefits*, p. 144.

pay its pension liabilities. Recently, for example, the PBGC has taken over the pension plan of at least "51,000 flight attendants, machinists and other employees" of U.S. Airways-Group, Inc.[44]

The problem of the underfunded defined-benefit plans is exacerbated by that fact that many of the companies are "in mature industries with older workers."[45] Indeed, and as Carolyn L. Weaver has pointed out, a government program such as the PBGC is, ". . . a form of industrial policy designed to prop up unionized companies in declining or restructuring industries."[46] Nonetheless, the PBGC has its own serious problem, namely, that it does not have sufficient assets to fund its liabilities.[47] One reason for the difficulty is that there are fewer defined-benefit programs and thus fewer premiums. But another reason, noted a few years ago by Steven A. Kandarian, then the Executive Director of the PBGC, is that both underfunded and well-funded pensions must pay the same premium. This suggests, as Kandarian and others have pointed out, that the insurance premiums paid to the PBGC do not in fact reflect risk.[48] Although the levied charge is not flat, it is clearly not adjusted to risk, as would be the case with any market-based insurance program. It is odd to have an insurance program that fails to charge for risk, a shortcoming that poses perverse incentives. There is a second problem at issue, also noted by Kandarian: An underfunded company may elect to raise its employees' pension benefits rather than granting them a raise. The cost is thereby deferred and, if the company fails, that cost may be picked up by others, namely, the PBGC.[49] This sort of problem is usually discussed in terms of "moral hazard," that alteration of behavior that occurs as individuals respond to incentives. Two years ago, in his testimony before congress, Steven A. Kandarian stated,

> the existence of the pension insurance program creates moral hazard, tempting management and labor at financially troubled companies to make pension promises the companies later find they are unable to keep. These unfunded promises increase the cost that chronically underfunded pension plans at weak

[44] PBGC Takes Over US Airways Pensions (2005). *Pittsburgh Business Times*, 2 February, available from http:/pittsburgh.bizjournals.com/pittsburgh/stories/2005/01/31/daily30.html?t=printable; as accessed 5 March 2005. For a list of the companies with the largest pension claims now held against the PBGC, see Table 4.3 in Weaver, Government Guarantees of Private Pension Benefits, p. 135.

[45] Samuelson, R. J. (2003). The pension time bomb. *The Washington Post*, Wednesday, July 16, A23.

[46] Weaver, *Government Guarantees of Private Pension Benefits*, p. 154.

[47] Schieber, S. J., & Shoven, J. B. (Eds.) (1997). The economics of U.S. Retirement Policy: current status and future directions. In *Public Policy Toward Pensions*. Cambridge: MIT Press, 24.

[48] Statement of Kandarian, S. A. (2003). Committee on Finance, United States Senate, March 11, available from http://finance.senate.gov/hearings/testimony/2003test/031103sktest. In her essay, "Government Guarantees of Private Pension Benefits," Weaver ably records a variety of problems that confront this government insurance program.

[49] Statement of Kandarian, S. A. (2003). March 11.

> companies impose on the defined-benefit system. Over time, this leads to higher premiums for all plan sponsors. Financially strong companies at some point will have had enough, and will exit the defined-benefit system, leaving only those which pose the greatest risk of claims. We need to make sure that the incentives in the system are changed so this doesn't happen.[50]

There is no doubt that some moral hazards occur as the cost of other benefits. For example, a moral hazard of unemployment insurance is that some persons will opt for unemployment rather than employment. Still, the moral of the story is that moral hazard arises when individuals are not granted responsibility or full responsibility for their actions. What should not be ignored is how or whether a certain structural feature of some policy or agency, such as the PBGC, works against the assumption of responsibility. The locus of responsibility is at the level of the firm, but a firm acts at the direction of its executives, managers, and boards of trustees.

It is not my concern to address the structural matters of the PBGC, for it is doubtful that a government insurance program can be structured in such a way that it will avoid moral hazards. This is not an *a priori* claim but a historical one based on the performance of government agencies.[51] At best, there is no reason to think that the government should be insuring pensions in the first place. It is my concern to remind business ethicists that alongside their devotion to regulatory policy, there is also the discipline of the market itself. It is the legal protection from failure that subverts market discipline and allows managers, as well as individuals, to retreat from responsibility in the marketplace. The discussion of responsibility ought to inform how we understand the actions of management and labor. One feature of responsibility is that one must be held accountable for one's actions and decisions. However, a guarantee against failure allows an escape from accountability. Market prices, including those that measure profit and loss, are a good means for holding individuals accountable, thereby ensuring responsibility. The market should provide a framework that encourages individuals, as Lucas stated, "to act

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[50] Statement of the Honorable Kandarian, S. A. (2003) Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, April 30; available from http://waysandmeans.house.gov/hearings.asp?formmode=view&id=322

[51] There are any number of works to consult. See for example, Sunstein, C. (1997). The Paradoxes of the Regulatory State. In *Free Markets and Social Justice*. New York: Oxford University Press. See also the classic work by Kolko, G. (1975). *The Triumph of Conservatism: A Reinterpretation of American History, 1900–1916*. New York: The Free Press and consult Stigler, G. J. (1975). *The Citizen and the State: Essays on Regulation*. Chicago, IL: University of Chicago Press and Yeager, L. (1983). Is there a bias toward overregulation? In T. R. Machan, & M. B. Johnson (Eds.), *Rights and Regulation: Ethical, Political, and Economic Issues* (pp. 99–126). San Francisco: Pacific Research Institute for Public Policy.

for reasons that are faceable," rather than reasons that are shameful. There will always be those who seek to strategize within the system. But we ought to ensure that the structures of the system provide incentives for honesty, responsibility, and effective attention to consumer preferences. These structures are preferable to those that encourage the shifting of burdens to others or that reward those who seek something for nothing. Such structures are also valuable tools against systemic risk that may affect the PBGC system.[52] Any structural reform of the PBGC, including its privatization, should take into account whether or not the effects will hinder or strengthen market incentives for responsibility. Anything else would be irresponsible.[53]

[52] Problems of systemic risk affect the banking industry as it is insured through the federal deposit insurance program. See Kaufman, G. G., & Scott, K. E. (2003). What is systemic risk, and do bank regulators retard or contribute to it? *The Independent Review* 7, Winter 2003, 371–391.

[53] For helpful remarks on earlier drafts of this essay, I thank Jeffrey Smith and Reva Wolf.

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Not *How Much* But *How*: The Ethics of Cash Balance Pension Conversions

Michael E. Johnson-Cramer and Robert A. Phillips

Over the past two decades, large- and medium-sized U.S. companies have been redefining the terms of the employment relationship, and while many scholars have explored the implications of these changes for job tenure, career development, and employee loyalty (Rousseau, 1995; Hall & Associates, 1996; Arthur & Rousseau, 2001), their impact on pensions and other employee benefits has attracted less attention. Nonetheless, a significant part of the responsibility for ensuring retirement security in this country falls on private retirement plans, and the evolution of these plans can have sweeping effects on retirees' prospects. The trend away from defined benefit pension plans, the widening gap in pension funding in the wake of stock market declines of the late 1990s, and the growing risk to pensions in embattled industries all portend serious threats to retirement security, even as 76 million baby boomers approach retirement age. The unsettled state of the private retirement system, together with the possibility of significant social impacts of individual corporate decisions concerning how to manage and restructure pension plans, has prompted scholars to begin to consider the ethical and social issues surrounding private pensions.

At the center of this discussion is a simple question: What moral obligations does a corporation have as a provider of retirement benefits to its employees? In this chapter, we address this question by examining the ethical issues raised by cash balance pension plan transitions. Cash balance pension plans are one of the most widely publicized developments in private pensions in recent years. They have also engendered a great deal of controversy. Critics have derided them as unfair, discriminatory, and opportunistic, and recent legal victories have given some credence to these claims (*Cooper v. IBM*, 2003; *Berger v. Xerox*, 2003). From this perspective, the advent of these plans raises serious distributive justice concerns, as cash balance plans redistribute the corporation's wealth away from legitimate claimants. Moreover, they do so in ways that (i) discriminate based on age, (ii) undermine the retirement security of long-tenure employees, and (iii) derive from morally suspect motives.

Though these arguments have been effective in the legal arena, it is important to consider whether they possess moral weight.

In this chapter, we contend that they do not. While the critique of cash balance pensions is a recent development, these arguments concerning the moral obligations of the corporation as pension provider have deep roots that can be traced back to the 1960s and the debate over pension law which led to the Employee Retirement Income Security Act of 1974 (ERISA). The conditions that gave rise to ERISA offered a clear moral basis for regulating employer behavior by providing funding, vesting, and insurance standards. Over time, however, these conditions have changed, and to base a moral critique of cash balance plans on them is to impose undue obligations on corporations. Of course, this does not absolve cash balance plans from moral critique. We advance a critique based on procedural grounds and argue that implementation procedures common to many policy transitions, rather than the substantive re-distribution of future retirement benefits, constitute the most important ethical concern.

We develop our argument in four parts. In the first part, we offer some background on the nature of cash balance pension conversions. In the second part, we outline three common distributive objections to cash balance plans and argue that the moral reasoning behind each objection constitutes an inappropriate claim against corporations as providers of retirement benefits. In the third part, we offer a procedural critique of cash balance pension plan conversions. In doing so, we contend that a corporation does owe some procedural obligations to employees as pension beneficiaries, even in instances where distributive claims fail. In the last part, we conclude by briefly discussing the theoretical and policy implications of our argument.

Cash Balance Pension Conversions

In 1985, assisted by consultants from Kwasha Lipton, a benefits consulting firm, Bank of America devised and implemented a new type of pension plan, a cash balance pension plan that differed in significant ways from traditional defined benefit plans. Many companies soon followed suit, and by 1993, 3% of all pension plans had cash balance features (BNA, 1996). By 2000, as many as 500 companies had adopted these plans, including approximately 20% of Fortune 500 companies (White, 2000). Though still legally considered to be defined benefit plans, cash balance plans afford benefits to employees based on the amount of a hypothetical account balance (Zelinsky, 2000). In simple terms, the cash balance plan is a hybrid in which employers continue to bear the investment risk entailed in providing benefits but employees have a better grasp of how much they are receiving in benefits because of the individualized account balance.

The key difference from traditional defined benefit plans is that cash balance plans have primarily straight-line accrual rates compared to traditional final-average plans that accrue at higher rates toward the end of an employee's career. Without additional provisions to address the needs of older employees, this alteration flattens somewhat the accrual expectations of employees who are already in the last few years of their career. The new accrual patterns, occasionally combined with exotic "wear away" provisions that slowed or halted the accrual of benefits for some employees for a set period after the transition, create only marginal cost-savings for companies. However, they tend to re-distribute greater overall benefits toward younger, shorter-tenure workers. Cash balance plans are also attractive to young employees, as they usually allow portability of benefits for people moving from one company to another.

In recent years, these plans have become controversial. Although most companies did allow some provision to ease the new plans' effects on older employees, transitions at a number of large companies, most notably IBM and AT&T, sparked heated resistance from employee groups and drew a great deal of media attention. One study of 100 cash balance conversions found that some form of conflict occurred at approximately one quarter of the companies making the transition (Johnson-Cramer, 2003). Employee groups took (and continue to take) a variety of actions to resist the implementation of the plans, actions which include litigation, union organization campaigns, public complaints during Pension Welfare and Benefits Administration (PWBA) and Internal Revenue Service (IRS) comment periods, criticisms on Internet chat sites (e.g., yahoo.com), and Equal Employment Opportunity Commission (EEOC) age discrimination complaints. At least three separate Congressional subcommittees have conducted hearings on the subject, and regulatory provisions concerning cash balance pension plans are pending in Congress, at the IRS, and at the EEOC.

The Case Against Cash Balance Plans

The controversy over cash balance plans is, at its roots, a moral conflict. While parties have resorted to litigation over legal rights and political maneuvering in the policy arena, critics of cash balance plans have made three assertions about the proper rights of employees as pension beneficiaries and about the proper role of corporations as providers of those benefits. The central thread of those arguments concerns how managers choose to distribute the wealth of the company both in retaining value for stockholders (seemingly at the expense of legitimate employee claims) and in allocating employment benefits among segments of the employee population. In this part, we evaluate these three arguments and, in each case, find an insufficient basis for either establishing

the moral status of cash balance plan conversions or answering broader questions about corporate obligations concerning retirement security.

Government Subsidies and Corporate Obligations

The first and most common argument against cash balance pension plans concerns the broad social harms entailed in depriving older employees of benefit accruals they might have expected under traditional defined benefit plans. Writing in an open letter to President Bush about proposed regulations to allow cash balance plans, Congressman Bernie Sanders expresses the argument in its starkest terms:

> We believe these regulations represent another serious blow to the retirement security of hard working Americans who have played by the rules in their companies only to see the rules of the game for rank and file employees change midway through their careers. Re-opening the floodgates for cash balance conversions will destroy what is left of our private pension retirement system.

The argument will seem familiar to any student of the history of pension reform. It was, after all, concern about broad social harms that motivated legislators in the 1960s to begin to contemplate the reforms that would become ERISA (Wooten, 2004). The failure of the Studebaker pension plan in 1963, which deprived 6,900 employees of retirement security, played a critical role in that legislative history. Then, as now, the argument relied on a fairly thin moral argument concerning public policy. The basic argument went something like this: (i) people need retirement security; (ii) corporations are rich and can provide retirement security to employees; (iii) therefore, corporations should provide retirement security.

Fortunately, we need not spend too much time on this argument in debating the role of the corporation as a provider of public goods, for the moral basis of pension regulation, at least in its 1960s incarnation, soon came to rest on a somewhat more sophisticated rationale.[1] In essence, reformers argued that corporations should provide retirement security not out of any obligation to employees themselves but as a fair response to the tax status granted pensions by the government. In this sense, government had a public policy interest in ameliorating the social harms associated with insufficient retirement funds. To address this interest, government would essentially subcontract to corporations its responsibility to provide retirement security. In return for accepting

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[1] This is, of course, an important debate in the business ethics field and usually centers around Friedman's (1962; 1970) critique of corporate social responsibility, in which he argues that it is primarily the role of government to provide public goods.

this responsibility, corporations would receive specific tax breaks for contributing to pensions. This "tax subsidy" argument has a clear moral basis; corporations with tax-preferred pension plans voluntarily become subcontractors to the government, make decisions that alleviate substantial social harms, and receive federal tax expenditures in return for providing retirement benefits. Like a contract, this tacit agreement possesses moral force, requiring both sides to keep their promises and allowing both sides to specify some of the terms (hence the moral possibility of pension regulation).

How well might this rationale apply to cash balance pension plans? At first glance, it seems to be an effective moral critique. If any employees stand to lose a significant proportion of their retirement benefits due to pension conversions, then we may reasonably conclude that corporations are reneging on their obligation and allowing these employees to suffer the harms associated with under-funded retirement. Unfortunately, the picture is more complicated. To start with, some data suggest that the provisions of most cash balance plans do not impair the ultimate benefit accrued by employees, assuming they retire at normal retirement age (Brown et al., 2000). In part, this is probably because most cash balance pension plans did, after all, include provisions to smooth the transition for employees already on the verge of retirement (PriceWaterhouseCoopers, 2000). To the degree that criticisms of cash balance plans rest solely on the harms wrought upon older employees, the argument is weakened by empirical evidence.

However, serious questions must also be raised as to whether corporations have reneged on their contractual obligation to the government by implementing cash balance plans. Here, we contend that the central issue is whether corporations initiated a contractual breach or is simply responding to a breach on the part of government. Given the history of fiscal and pension reform over the years since ERISA, a valid argument may be made that the government, rather than corporations, has reneged on the "tax subsidy" promise. Starting with the passage of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Congress embarked on a series of acts that steadily eroded the tax-preferred status of pension funds. These included the Deficit Reduction Act of 1984, the Tax Reform Act of 1986, and the Omnibus Budget Reconciliation Acts of 1987 and 1993. These efforts to reduce the tax expenditure associated with private retirement plans represent a serious change in the conditions that gave rise to the "tax subsidy" argument. Tracing the financial impact of TEFRA and subsequent efforts to reduce pension-related tax expenditures, Scheiber (2002) notes that, by 1993, the amount of employee compensation that a corporation could consider when funding a private retirement plan had dropped from $235,840 to $150,000. In the aggregate, these restrictions reduced the tax advantages given to corporations even as they served the political purpose of imposing fiscal discipline on tax expenditures.

For our purposes, the political merit of these curtailments is less relevant than their impact on the moral argument that cash balance pension plans (a) represent a breach of trust by corporations and (b) create a large social harm *for which corporations are responsible.* We suggest simply that the conditions that gave rise to the tax subsidy argument in the 1960s have changed radically throughout the 1980s and 1990s. With that change, corporations are, in general, less obligated to provide retirement security to employees, proportional to the reduction of tax preferences.[2] Of course, it is not a simple matter to calculate this sense of proportionality, and corporations clearly owe important moral obligations to employees themselves. For example, though the tax subsidy argument in the 1960s also gave rise to the vesting standards that are central to ERISA, the breach of the tax subsidy does not eliminate the corporate obligation to protect those benefits already accrued by employees. No standard of promise-keeping would allow corporations to breach this obligation. However, in general, the changing conditions devolve many of the moral obligations from the firm–government relationship to the firm–employee relationship, where they may be legitimately renegotiated.

Age Discrimination and Cash Balance Plans

Another argument against cash balance plans concerns whether they discriminate based on age. If, as we suggested above, the erosion of tax preferences devolves corporate obligations from the firm–government relationship to the firm–employee relationship, the central moral problem in the firm–employee relationship is whether corporations have unfairly violated their obligation to older workers. Because cash balance formulas generally allocate benefits based on two components, salary and prospective investment return, younger employees accrue higher investment return components simply by virtue of having more years before normal retirement age (Zelinsky, 2000). Of course, this problem is compounded by the fact that cash balance plans are generally introduced in environments where older employees had expected to receive not lower rates of accrual in their final years but higher. Recent cases, such

[2] Some might argue that the reduction of tax expenditures is irrelevant, given that so few plan sponsors fully fund their pension obligations. The issue of plan underfunding is surely a serious moral issue in its own right (addressed by other chapters in this volume). Any company failing to fund its pension obligations appropriately should be judged harshly from a moral standpoint, regardless of whether they implement a cash balance plan. However, we would argue that the very companies that do fund their obligations are the "good actors" that least deserve to be judged as promise-breakers vis-à-vis the tax subsidy and, thus, should not be judged negatively for implementing a cash balance plan.

as *Cooper* and *Berger*, have affirmed that this approach may violate the letter of the anti-discrimination provisions of ERISA. Our challenge is to weigh the moral arguments on either side. There are at least two distinct moral considerations in arguments against age discrimination: age per se and contribution. We explain and evaluate each in turn.

First, it may be argued that discriminating against a person based on age is to treat individuals unequally on the basis of a morally arbitrary feature. Although allocation of rights and rewards as a function of merit within firms is generally believed to be acceptable (Phillips & Margolis, 1999), youth is rarely a source of such merit on its own. The mere fact that any change in firm strategy or policy will adversely and differentially affect different groups of employees does not rule out all policy changes. But the basis for the differential effects should have a solid moral foundation. An argument against age discrimination, therefore, concerns not whether it is just to distribute benefits unequally but whether it is just to premise differential treatment on false derogatory judgments about a group. Put simply, age discrimination is often unjust because it undeservedly accords lower status to older people. Critics of cash balance plans would charge that treatment accorded older employees in cash balance pension plans seems, at least in part, premised on the notion that older employees offer less value to the company and possess fewer of the skills necessary to the company's success. To assume such things falsely and to act based on this assumption, the status argument suggests, is to treat these employees unjustly (Cupit, 1998).[3] The lynchpin of this argument, however, is that the assumptions are ill-founded. Cupit (1998, p. 710) explains:

> Age discrimination will be unjust (for reasons deriving from this account) only if it constitutes treating people as inferior on account of their age (when they are not so inferior). Age discrimination which does not constitute such treatment need not be thought unjust (so far as this account goes).

[3] One argument to which we devote little attention is the simplistic notion that these plans are unjust merely because they create inequalities between two groups – one old and one young. Cupit (1998) effectively dismisses the justification underlying this simplistic notion of age discrimination, but even if we accept inequality across age groups as a morally suspect condition, we may conclude that cash balance pension plans result in less inequality, when age groups are compared in terms of complete life benefits (cf. Daniels, 1988; McKerlie, 1992). Younger employees will rarely spend 20–30 years at a given company – a decision that downsizing and the evolving social contract have largely taken out of the employees' hands (Altman & Post, 1996). Moreover, many private pension plans, especially those that continue as traditional defined benefit plans, seem less stable and unlikely to endure to a point where younger employees will ever receive benefits. Consequently, younger employees are less likely to accrue nearly as many benefits in later years under traditional final-average plans as the earlier generations to whom they are compared.

Judging the accuracy of derogatory assumptions about older employees is problematic, to say the least. However, in many of the most controversial cash balance cases, just such an argument can be made. Companies that find themselves in turbulent industries such as high technology, telecommunications, and the energy sector may find that older workers possess few of the skills necessary to compete in these industries. Companies seeking to change entrenched corporate cultures may find older employees less willing to give up long-held beliefs than younger employees. In short, assumptions on which some (though not all) cash balance plans are premised may well treat older employees differently – sometimes justly so. But age per se may not be the most compelling argument concerning disparate treatment of older employees.

The more compelling rationale underlying claims of age discrimination is not based simply on the fact that the person is older. Rather, age discrimination may be criticized as a failure to reciprocate contributions that older employees have made to the company. We do not feel for Willy Loman (Miller, 1949/1998) and Shelly "The Machine" Levene (Mamet, 1982) simply because they are old, but because their past contributions seem to have been forgotten by the new guard (among other sources of pity). Similarly, as Congressman Sanders's view (cited above) of cash balance pension plans as "broken promises" reflects, the objection to cash balance plans as age discriminatory rests on the idea that corporations are failing to live up to obligations incurred when employees were younger. This argument has deep roots in organizational ethics. Reciprocity has a reasonable claim as a universal moral norm, and the idea that corporations must honor such obligations dovetails with arguments we have made previously from stakeholder and social contracts perspectives (Phillips, 2003; Phillips & Johnson-Cramer, 2006). Elaborating his principle of stakeholder fairness, Phillips (2003, p. 92) writes:

> Whenever persons or groups of persons voluntarily accept the benefits of a mutually beneficial scheme of co-operation requiring sacrifice or contribution on the parts of the participants and there exists the possibility of free-riding, obligations of fairness are created among the participants in the co-operative scheme in proportion to the benefits accepted.

Inasmuch as age is often highly correlated with historical contribution, changing the terms of employee pensions after the employee contribution has been made fails to achieve reciprocity.

The contribution-based argument breaks down, however, when the principle is applied specifically to pensions, where three additional considerations arise. First, in considering pension benefits, the issue of age is conflated with the issue of contribution. While age sometimes provides greater opportunities for contribution and thus greater claims to reciprocity, the two concepts

are meaningfully distinct. If it is possible (as we argued above) to judge that younger employees make a greater contribution, appeals to reciprocity raise no barrier to a firm's discretion to offer them a greater proportion of available pension benefits. Second, it is not altogether clear that future accruals constitute a reasonable part of what employees can expect for current contributions. Certainly, legal obligations play some role in shaping legitimate expectations, and employers have almost total discretion at law to change or to terminate pension plans, so long as it does not retract those benefits already accrued (for a thorough review of the legal implications, see Muir, 2004). Thus, while it would surely be unjust for companies to deny accrued benefits representing the established value of past employee contributions to the cooperative scheme (Maitland, 1989), reciprocity considerations set no clear boundaries around prospective distributions of benefits. Third, the contribution-based argument raises the question of how companies should weigh current versus past contributions. Older workers have often accumulated a record of historical contributions to their company, but the notion of reciprocity offers no particular guidance for weighing these past contributions, which have been attenuated by time and more recent contributions. Consider, for example, a sports team's obligation to a long-time player who has contributed to the franchise for many years. Few would argue that the franchise is unjust to offer greater compensation, moving forward, to a younger player. Here, again, the contribution argument, though reasonable, does not rise to an unambiguous condemnation of cash balance plans as unjustly age discriminatory.

The question, which arises in response to accounts based on age and contribution, is whether age discrimination occurs when firms alter the terms of their pensions and whether, indeed, age discrimination is even the best lens through which to view the question of changing pension plans. It may be that current arguments against altering pensions that rely on age discrimination are actually based on one or more of these deeper justifications. Also presenting difficulties for the age and contribution arguments is the fact that, in general, pension plans are not converted individually for each employee based on her specific age and historical contribution. Rather, pension plans are mostly altered for entire groups, making it challenging to consider individual ages and practically impossible to consider contribution in the decision. We discuss the prospects for the former (i.e., "grandfather" clauses in pension conversions) presently. Though age discrimination may exist or even motivate some cases of pension alterations, we do not believe that discriminating against older employees is the primary motivation behind most firms' decision to change their pension plans. As we will argue below, we contend that other moral concerns provide more powerful arguments for managers to consider as they undertake changes to pension plans.

The Motivation for Cash Balance Conversions

A third argument frequently raised in the debate over cash balance pension plans and, more broadly, over how companies can ethically alter their plans concerns managerial motives. Cash balance pension plans are often cited by critics as evidence of managerial opportunism and self-interest. In his study of conflict over cash balance plans, Johnson-Cramer (2003) refers to employee comments at several Fortune 500 companies engaged in cash balance conversions. Employees accuse managers of "corporate greed" and "feathering their nests" (Johnson-Cramer, 2003, p. 93). Employees at another company used an on-line newsletter to argue (p. 94):

> [The company] lured us along with that carrot for twenty to twenty-five years and then they ate the carrot. [The company] then explained that it was what we wanted. Even though they never asked us for one word of input. Do you smell a rat? Do you smell a liar?
>
> And,
>
> [The company] is the school yard bully. Once the bully is confronted, without regard for the consequences, he is rendered powerless. His stock in trade is fear and intimidation. If you do not buy what he is selling, the bully is nothing more than a pathetic joke.

The quotes not only illustrate the centrality of managerial motives to employee discourse about cash balance transitions, but they also raise an important theoretical question: What constitute legitimate motives for a corporation to alter the terms of a pension plan? Ethics scholars have only recently taken up such questions (Mittelstaedt, 2004), and the most compelling argument, to date, suggests that situations of dire necessity justify firms inflicting the harms associated with radical alterations to private pensions (see Windsor's chapter in this volume). Otherwise, alterations constitute an illegitimate form of opportunism perpetrated at employee expense.

What makes this line of reasoning interesting is that the legitimate motives for changing plans are so far removed from the corporate motives for originating pensions. The railway industry first conceived of pensions as a means to quell labor unrest and to retire aging workers who were no longer productive (Sass, 1997). Later, companies introduced pensions in an attempt to prevent workers from leaving their company (Hannah, 1986). Recognizing such business exigencies as legitimate motives for providing pensions, early regulations (e.g., the Federal Welfare and Pensions Plan Disclosure Act of 1958) merely sought to preclude behavior based on the most obviously immoral motive: self-dealing (McGill, 1979). What little empirical evidence exists on

the motivation for cash balance pension plans suggests that managers are similarly motivated by business exigency. Improving employees' appreciation of a plan, facilitating communications with employees, the ability to show lump sum values, and the value to recruitment efforts figure highly in every study of employer motivation for cash balance conversions (Brown et al., 2000; Johnson-Cramer, 2003; Muir, 2004).

Of course, this still begs the question of why some motivations should be considered more legitimate than others. Even if corporations are motivated primarily by economic interests in both forming and altering their plans, what is the moral status of these considerations relative to other possible motives? We contend that this question is both unnecessary and impossible to answer. Critics have not, thus far, explained what other possible motives would constitute legitimate ones if business concerns do not qualify. Absent a positive model, it is difficult to imagine what this standard would entail. If we require managers to act out of an intrinsic desire to be fair-minded and dismiss (as we have above) the accusation that managers have failed to reward past contributions, we must ask why preferring employees in all pension decisions constitutes fairness in a corporation with multiple legitimate stakeholders. Moreover, we have every reason to expect that managers are trying to fulfill these multiple obligations and that this motivation is legitimate. Satisfying multiple, legitimate stakeholder demands is a morally valid motivation, premised on the value of reciprocity toward other members of the cooperative scheme surrounding the corporation, and on the whole, it appears that most stakeholders would favor (and benefit from) cash balance pension plans (Muir, 2004).

In sum, critics of cash balance pension plans consider them unfair because they proceed from improper managerial motives. The empirical evidence suggests otherwise. In fact, managerial motives do not fall neatly into categories of dire necessity ("if we don't change our pension, the company will fail") and self-interested opportunism ("if we do change our pension, we'll get rich"). The problem with current evaluations of managerial motives is that none offer any rationale for dismissing other legitimate stakeholder demands on managers. Ironically, one of the strongest objections to many of ERISA's most basic provisions concerning pension funding, vesting, and benefit accrual was that regulations would deprive corporations of the flexibility to use pensions as business tools (Taylor, cited in Wooten, 2004, 104ff). The criticism of corporate behavior on the grounds of managerial intent justifies this concern to the fullest. While it is reasonable to argue that employee claims concerning cash balance pensions should take precedence – arguments dealt with primarily in the previous two subsections – there is little reason to question managerial motivations.

A Procedural Critique

Are cash balance pension plans morally acceptable? Do they satisfy the moral obligations of the corporation as a provider of retirement benefits? To this point, given the apparent weakness of the central arguments against cash balance plans, it would seem reasonable to conclude that the plans are morally acceptable and do satisfy the moral obligations of the corporation. Yet, our argument about their substantive acceptability does not fully excuse cash balance transitions from further ethical scrutiny. In this part of the chapter, we propose two arguments that criticize procedural aspects common to cash balance pension transitions.

Our arguments proceed not only from the principle of stakeholder fairness cited above but also from Integrative Social Contracts Theory (ISCT; Donaldson & Dunfee, 1999). ISCT posits a morally significant role for the local norms that govern firm behavior relative to its community of stakeholders. Drawing on the social contracts tradition, Donaldson and Dunfee suggest that these local norms have moral force insofar as they are *authentic* (i.e., freely and fairly agreed upon by community members) and *legitimate* (i.e., consistent with a thin set of universal "hypernorms" often phrased in negative terms, such as "do not kill"). Elaborating on this logic, we have argued that two additional principles must constrain the process of contracting in order for it to produce reasonable and binding moral norms (Phillips & Johnson-Cramer, 2006). In this section, we cite these principles in order to determine what *procedural* obligations a firm might owe its employees in changing the terms of its private pension plan. We then draw on findings from an empirical study of cash balance pension conversions to determine whether these standards have been met.

The Stakeholder Discourse Principle

Throughout the discussion to this point, we have acknowledged that the conditions of retirement plans set out by managers constitute a form of promise. It is only a short leap to conceive of these promises in contractual terms. Work for a period of time, the company promises, and you will begin to accrue retirement benefits. Of course, as with all contracts, the terms are intended to be binding. The very purpose of a contract is the self-imposed restriction of one's freedom in return for the voluntary restrictions of another party (Corbin, 1952). We have argued above that the transition to cash balance pensions does not, strictly speaking, constitute a contractual breach by employers, as no company has ever made it a condition of retirement benefits that it will not change the plan. However, if contracts (including social contracts) are to be binding, it seems

only reasonable that contracting parties have some ex ante opportunity to discuss and negotiate the terms prior to being bound to them.[4]

We frame this basic principle as the stakeholder discourse principle (Phillips & Johnson-Cramer, 2006): that, particularly in times of conflict and transition, firms must create systems for the exercise of voice for all parties to a contract. Moreover, lest voice be reduced to vox clamantis in deserto (a voice crying in the wilderness), such systems must foster genuine dialogue (Calton, 2006), such that concerns are not only voiced but also heard and incorporated into the decision-making process, even if not the substantive policy. Of course, fair contracting is not the only moral justification for requiring stakeholder discourse. If, as we have suggested, reciprocity constitutes a fundamental requirement of economic behavior, a hypernorm to borrow Donaldson and Dunfee's term (Donaldson & Dunfee, 1999; Phillips & Johnson-Cramer, 2006), then access to the policy formulation process may be as much an obligation generated by participation in cooperative systems as the allocation of substantive benefits (Phillips, 2003).

In terms of retirement plan alterations, the formulation of a new or restructured plan represents just such an opportunity for stakeholder discourse. If companies expect the plan to be binding (i.e., for employees to work in accordance with the plan without the resistance or conflict that followed in so many cases), they have a moral obligation to consult with, or engage, employees in the policy formulation process beforehand. The evidence concerning cash balance transitions suggests that this condition was often not met. Studying four conversion processes in detail, Johnson-Cramer (2003) found significant variation in how many opportunities for participation companies offered to employees, how long these opportunities lasted, how far in advance of the policy announcement these opportunities occurred, and how dialogic the exchange was between managers and employees. We contend that the lack of stakeholder engagement in many cash balance pension transitions constitutes an important moral basis for criticizing these plans. Those cash balance transitions that did not evidence stakeholder discourse violated the firm's moral obligations not because the final policy did not reflect the interests of older employees but because few such processes made allowance for the expression of these interests at all.

The Avorum Principle

Our second point concerns the moral status of benefit reductions. As we have discussed above, a central issue in the conventional critique of cash balance

[4] Freeman (1992) arrives at a similar conclusion in his examination of fair contracting; however, he largely asserts the principle by fiat rather than couching it in a more systematic logic such as the contractualist tradition.

plans is whether firms have the right to deprive older workers of benefits that they had expected to earn during their final years of employment. In weighing the substantive objections to this practice, we have dismissed both the argument that such changes are the privilege of managers at law and the criticism of cash balance plans as unfair or discriminatory. Here, we introduce an alternative logic. ISCT holds contracts as morally binding insofar as their authenticity rests on the condition that parties have the ability either to exit or to voice concerns – thereby garnering support from other community members for alternative norms.

When a change occurs in the contract, many parties (in this case, employees) will not have the opportunity, by necessity, to voice their concerns ex ante. Even where a firm satisfies its obligation concerning stakeholder discourse, it can rarely involve everyone. Yet, these employees will continue to subscribe to norms which, though no longer consistent with those posited by the firm, are morally legitimate. They should have some opportunity to challenge these norms ex post, or in the event that other employees find the new contract acceptable, to exit freely from the organization. Thus, the Avorum principle (Phillips & Johnson-Cramer, 2006) holds that those subject to stakeholder obligations (or contracts, in the sense envisioned by many social contractarians) should make every effort to respect the former terms of the obligation/contract during times of transition.

Of course, cash balance pension transitions vary in the degree to which they satisfy Avorum. Some plans "grandfathered" older employees; others did not (Zelinsky, 2000; Johnson-Cramer, 2003). Failing such grandfathering provisions, employees who reasonably expected certain benefits had no time to adjust their expectations or to express concern (cf. the role of engagement in ethical firm–stakeholder relations). Notice, however, that the central concern, here, is procedural. We do not argue that firms cannot reduce prospective benefits to employees (even older employees) but that such reductions must take place in such a way that, given the complexity of retirement benefit plans and the timeliness that most firms seek during transitions, employees have time to exercise their other rights as participants in the cooperative system (voice or exit) both ex ante (Stakeholder Discourse) and ex post (Avorum).

Conclusion

In sum, we have argued that cash balance pension plans raise a number of important ethical issues regarding the obligations of companies in providing pension benefits to their employees. Specifically, these issues include both substantive concerns about the fair distribution of benefits across multiple stakeholder groups and procedural concerns about how managers formulate and

implement changes to these plans. Critics of cash balance pension plans, we have suggested, rely primarily on the former set of claims in their case against cash balance plans. We argue, instead, that procedural concerns offer a more readily defensible moral critique of cash balance plans under current conditions. Corporations have an obligation to implement plans in such a way that (a) genuinely engages employees in the decisions that affect them and (b) recognizes the historical commitments of the firm, allowing employees to exercise their rights as participants in the cooperative system. This argument has important theoretical and policy implications. In this final section, we attempt to put this chapter in its proper perspective relative to these two domains.

Theoretically, the arguments presented here concerning cash balance plans extend not only to other issues surrounding private pensions but also to firm–stakeholder relationships as a whole. They suggest, in short, that firms do have some procedural obligations in how they manage stakeholder relationships. In his seminal work on stakeholder management, Freeman (1984) argues the strategic, or instrumental (Donaldson & Preston, 1995), importance of stakeholder management procedures; these include active communication, monitoring of stakeholder interests, and negotiation of firm–stakeholder policies. In time, the stakeholder research domain turned its attention from instrumental to normative concerns, from the question of how firm behavior toward stakeholders affects financial performance to the question of how firms as moral actors should treat stakeholders (Freeman & Gilbert, 1992; Evan & Freeman, 1993). Along the way, ethicists turned from an evaluation of stakeholder management procedures to the more substantive concerns of how firms distribute their wealth. This turn prompted Phillips (2003, pp. 25–26) to write:

> Who gets how much of the organizational outcomes pie is an important question, but so is who gets a say in how the pie is baked. Stakeholder theory is concerned with who has input in decision-making as well as with who benefits from the outcomes of such decisions. Procedure is as important to stakeholder theory as distribution.

To date, there has been little effort to elaborate the procedural obligations of firms toward their stakeholders. This chapter offers a first step in that process, applying two procedural principles that are well grounded both in the need for reciprocity in firm–stakeholder relationships and in principles of fair contracting. This is, of course, not the final word on procedure, and future work will need to elaborate these obligations more systematically.

More wide-ranging are the implications of this argument for public policy concerning the regulation of private pensions. Without dwelling long on the history of employment benefits in the United States, we have observed simply that corporations have voluntarily assumed some role in the provision of retirement benefits for over a century. Over that time, a complicated body of

law has emerged to regulate how companies manage these benefits, not limited to pension law, IRS rules regarding taxation of benefits, age discrimination statutes, and particularly ERISA. While the regulated nature of pensions grants legal rights to plan participants and imposes legal obligations on corporations, the legal merit of claims against cash balance pension plans does not preclude the consideration and, in some sense, reconsideration of the moral obligations of corporations providing private pensions.

Over the past three decades since the passage of ERISA, many of the conditions that gave rise to its provisions have changed significantly. The curtailment of tax preferences in the name of fiscal discipline erodes seriously the moral argument concerning the reciprocal obligations of firms for public expenditures. Following from this argument, one may also question the moral justification for specific provisions of pension law. Some have clear moral grounding, independent of the "tax subsidy" claim. For example, the obligation not to take away accrued benefits, so central to ERISA, is clearly grounded in the moral obligations both to keep promises and to respect property rights. At the same time, we may well reconsider the degree to which corporations can legitimately use pensions for their historical purposes (i.e., retaining older workers) in the absence of a compelling requirement for equal treatment. By no means is this argument meant to suggest that corporations do not have important legal obligations engendered by current law. Neither do we suggest that these legal requirements lack the moral grounding that normally accrues to corporations to comply with law. What we do suggest is that, with due respect to the principles of stakeholder discourse and Avorum, current conditions give corporations a powerful moral argument on its side in justifying less restrictive pension regulations, including those concerning the future of cash balance pension plans.

Of course, the need to reconsider the moral obligations accruing to corporations, above and beyond legal obligations, cuts both ways. Rules regarding disclosure of pension changes are central to pension law. Nonetheless, they do not begin to address the moral obligations the corporation has, according to our argument, to engage with employees in renegotiating the terms by which they participate in the cooperative scheme. Corporations do have an obligation, for example, to grandfather employees who will be adversely affected by conversions without the procedural benefit of exercising voice or exit in response to the change. They also have an obligation to allow employees to participate meaningfully in the formulation of a revised plan. These obligations may not be well served by enshrinement in legal form. After all, regulations are not necessarily the most effective way to produce uniform or meaningful procedural change in corporations. Yet, they remain important moral constraints on corporations as provider of retirement benefits.

In conclusion, the debate over private pension reform in the United States remains a pressing issue, as firms re-examine their employee benefits practices

and as we anticipate the impact of the retirement of the baby-boom generation. Hopefully, in the midst of the debates to come, we will not forget that, underlying the policy deliberations concerning how corporations manage private pensions, there are important, if sometimes subtle, moral debates and undercurrents. While these frequently require more of corporations than self-interest would dictate, ethical considerations may occasionally require less than critics would prefer.

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7

Ethics of Corporate Retirement Program Changes

Duane Windsor

Any worker in the U.S. private sector should be concerned that expected voluntary retirement age will be postponed significantly and that expected retirement benefits are at increasing risk. There is underway a fundamental shift in employment and retirement conditions relative to the long period 1950–1990 shaping today's expectations. A majority of Americans oppose private accounts and major changes to Social Security (*Houston Chronicle*, 2005b). The Bush Administration proposed significant changes to private pension plans and a 58% increase in company premiums for the Pension Benefit Guaranty Corp. (PBGC), under great fiscal stress (Geller, 2005). One long-term employee of MCI (absorbed by WorldCom) reportedly invested all his 401(k) funds into the company stock: more than $1 million intended for early retirement fell to less than $500 after the WorldCom collapse of 2003 (McClam, 2005). Global development theoretically could turn the terms of trade against U.S. labor (Samuelson, 2004).

This chapter focuses on the ethics of one-sided changes in corporate retirement programs that erode the expected future benefits of presently covered workers and retirees (Ad Hoc Coalition to Restore Retirement Security, 2004). Companies are moving toward defined contribution, cash balance payoffs, health benefit caps, and elimination of some or all benefits for employees and current retirees. There are suspected instances of malfeasance of retirement plan administration by companies. Affected individuals assert violation of moral expectations if not legal rights, and make political claims arguing social and stakeholder responsibilities because enforceable legal rights are non-existent or weak. The moral claims assert reasonable expectations based on implicit promises inducing labor effort and long-term loyalty to the company. The political claims assert implicit obligations based on urged social standards of fairness and justice. This chapter identifies and assesses key ethical and social issues arising from conflict of interests. The chapter is concerned with ethical and social dimensions of lawful changes rather than with illegal actions, except as lax governmental enforcement or tolerable cost of civil litigation facilitate misconduct.

There is a tripartite distinction among law, ethics, and public policy (Wilson, 1989). Law is a set of social rules concerning criminal and civil litigation matters. Ethics deals with arguments concerning right and wrong actions and is a set of principles (or values). Public policy concerns distribution of gains and losses, and the broad question of whether there is sufficient private and/or public retirement security for individuals and who should provide it.

The situation is generally as follows. The changes of immediate interest are typically lawful (i.e., not forbidden by statute, regulation, or contract) no matter how morally awful or strategically unenlightened. Benefit erosion reflects a reduction in expected, but never guaranteed, future welfare. On-going changes violate largely implicit promises not amounting to legally binding contracts: each implicit promise created an expectation amounting to an inducement to labor without guarantee. The relationship is effectively one of trust in a company and in conditions. Companies make changes adverse to workers and/or retirees out of self-interest with financial benefits flowing to executives and/or investors in a zero-sum game (i.e., win–lose contest). Incentives and attitudes in such a contest, given lax governmental enforcement or tolerable costs of civil litigation by injured parties, may lead companies to try determining the real limits of unlawful conduct including violation of contract terms. Where changes are made in a zero-sum contest, workers and/or retirees do not have sufficient power as stakeholder groups to resist directly within the contest and must seek a combination of legal remedy (if any), public opinion mobilization, or public policy change. Such strategies require that workers or retirees assert moral claims concerning implicit promises and/or political claims concerning stakeholder and/or social responsibilities of companies. Social responsibilities reflect repercussions of violating promises and stakeholder duties.

The ethical dimension concerns situations where employers can make or compel unilateral changes in an existing arrangement (not necessarily an enforceable contract) adverse to employees and/or retirees without violating applicable laws (criminal and civil). The situation involves three questions. What are the moral rights of employees and/or retirees and the corresponding moral duties of employers, if any? What are the consequences (i.e., repercussions) of on-going changes in corporate retirement security programs for society and government? What should the general public do about these moral rights and duties in cases of conflict interest of and/or social repercussions, if anything? These questions address rights and duties reasoning on the one hand, and consequences reasoning on the other hand. Public policy concerns may depend partly on whether erosion of expected benefits occurs above a socially accepted minimum standard for retirement security in relationship to Social Security.

The chapter suggests three general conclusions. A first conclusion involves normative ethics. It is difficult rigorously to assign moral rights and duties

within this particular zero-sum game. The contest occurs wholly on the production side of the market: what workers and/or retirees lose, investors gain (laying aside the principal–agent problem) – independently of consumers on the demand side of the market (see Adam Smith, *The Wealth of Nations*, 1776, Book Four, Chapter 3, Part 2, and Chapter 8). The claim would have to be for strengthened rights of employees at zero cost to consumers. Law may not be able fully to handle economic misconduct (Adam Smith, *The Wealth of Nations*, 1776, Book One, Chapter 10, Part 2). Moral claims concern inducement by implicit promise; political claims appeal to social consequences and general standards of fairness and justice. Implicit promises or implicit obligations and even some contract terms (such as compensation and benefits following Chapter 11 reorganization or Chapter 7 liquidation) are subject ultimately to a "ceteris paribus" ("other things being equal") assumption. The assumption is reasonably valid under relatively static conditions but not under dynamically changing conditions. Available theories are essentially a dispute between rights/duties and altruism on the one side (business ethics, corporate social responsibility, good corporate citizenship, and enlightened stakeholder management) and fiduciary "responsibility" (i.e., financial opportunism) grounded in investor property rights and economic efficiency of relatively free markets on the other hand. Fiduciary responsibility draws on a combination of property rights and the economic advantages of markets. The dispute is essentially between fairness to employees and efficiency of investor-oriented markets (Englander & Kaufman, 2004). This zero-sum contest played over money on the production side of the market has been interpreted as highly moral conduct within a philosophy of market efficiency in which "Altruism is an anti-life moral code" (Locke & Noel, 2004).

A second conclusion involves descriptive ethics. Executives making unhappy changes to implicit promises may act of necessity to avoid bankruptcy. But executives operate amorally under cover of fiduciary responsibility doctrine if they simply increase earnings by such changes. Executives themselves benefit from increased earnings and are not neutral, acting simply on behalf of investors. No one should expect much else from such executives (Adam Smith drew similar conclusions about the directors of the British East India Company in *The Wealth of Nations*, 1776, Book Four, Chapter 7, Part 3). Drawing on Machiavelli (de Alvarez, 1980, pp. xv–xvi), a test for whether management is engaged in amoral self-interest or arguably moral (i.e., fiduciary) conduct on behalf of investors is the degree to which identifiable deception is practiced in that conduct. Typically, loopholes, fine print, and legal cost deterring civil litigation by harmed parties are exploited. Inducement of labor may have been made by one generation of executives and escaped by another generation of executives not feeling morally bound by prior non-contractual practices, since not legally defined. Such executives also likely test the limits of legal constraint.

A third conclusion is that social trust erodes with such business practices. Everything becomes steadily reduced to a market peopled by rational self-interested actors subject to minimalist laws (see Ferraro et al., 2005) which they also seek to influence to advantage. Ultimately, no stakeholder (e.g., customer, employee, investor, or retiree) can trust business management on any matter further than the strict, enforceable letter of the law (assuming non-corrupt government, a trust then also subject to erosion) or calculable stakeholder power (which may well erode with time). Erosion of trust and expansion of laws may be the overriding social repercussions. Fiduciary responsibility condemns discretionary altruism by management or even investors acting through the company while permitting strategic altruism as a stratagem for resisting even less desirable adverse changes in public policy or stakeholder sentiment. Strategic altruism or enlightened stakeholder management are effectively synonyms for satisfying disaffected stakeholders who can harm the company. This position associates with an argument that firms do need no more than practice legal compliance and strategic altruism while leaving any other considerations to public policy (subject of course to self-interested influence efforts by the firms). Beneath these competing positions is ultimately whether one views society as a competitive and Darwinian regime with no rights or duties other than as defined by public policy, or a cooperative and non-Darwinian regime with rights and duties defined by ethics and values beyond public policy. Everyone must treat a company as if always operating amorally.

The remainder of this chapter proceeds in the following manner. The second (next) section marshals some information concerning changes in corporate retirement programs. The third section analyzes the ethics of corporate retirement program changes within a win–lose contest which has social repercussions. The final section places the ethical and social dimensions of on-going changes in corporate retirement programs within the broader context of economic performance in an increasingly contested global marketplace.

Some Information Concerning Changes in Corporate Retirement Programs

Corporate retirement program security has become a vital issue in the wake of industry effects of the 9/11/2001 terrorist attacks, the corporate scandals of 2002–2004 (e.g., Arthur Andersen, Enron, Tyco, and WorldCom), and the effects of the recent economic downturn. The Securities and Exchange Commission (SEC) (*Houston Chronicle*, 2004c) is examining whether companies have designed pension fund accounting to manipulate earnings. The European Union (EU) is addressing pan-European pension operations and regulation (Marshall, 2004).

Erosion of retirement program benefits can take place under two fundamentally different conditions, although both circumstances are zero-sum contests. One condition is external financial stress on the company due to bankruptcy or declining income trending into bankruptcy. This condition reflects necessity arising in uncontrollable external factors (e.g., economic changes, competition, etc.). Necessity can be an overriding consideration relative to moral claims, especially in the forms of implicit promises and obligations. Such necessity may have a normative justification; public policy must address the conflict. The other condition is internal opportunity and incentive for exploitation of labor whether under stable earnings or rising earnings. Such exploitation does not arise in external necessity but in personal preference, even if clothed in a doctrine of fiduciary responsibility. Such conduct does not have a normative justification. The issue is whether public policy should address the matter and if so how.

If a firm persistently suffers net losses trending toward bankruptcy, then distribution of losses becomes a matter of conflict between the interests of investors and the interests of employees and/or retirees. In a zero-sum contest, someone must bear the loss. Bankruptcy becomes a contest between investors and creditors. Employees have an incentive to force losses onto retirees as a final resort (Strope, 2004). Maintenance of retiree benefits may reduce employee jobs and/or compensation. The investors are likely to bear a loss already due to decline in share price and/or dividends. Compensation contracts may need to be adjusted. Flight attendants at again bankrupt U.S. Airways approved tougher work rules, 8.4–9% pay cuts, and limitation of pay raises to 1–2% during 2007–2011 (*Houston Chronicle*, 2005a). A bankruptcy judge then warned the hold-out machinists' union to accept reductions. Adjustment is not voluntary but coerced of the employees by threat of employment losses or bankruptcy. The same logic may apply to retirement and health benefits. The difference is that the retirees cannot be coerced but only deprived; and retirees are perhaps less able to obtain jobs. In the Enron bankruptcy, the immediate recovery of Enron employees was capped at $4,500 (AFL-CIO, 2002). The AFL-CIO has recommended that Congress change bankruptcy laws to afford employee claims for severance and pension fraud "parity" with the claims of other creditors.

If a firm not under such necessity generates earnings by reduction of promised benefits for employees and retirees, then investors and executives gain at the expense of employees and retirees. This opportunism may be justified on grounds of property rights and the utilitarian outcomes of efficient markets. However, deception in forms of loopholes, fine print, costs deterring redress, and malfeasance may be an expected feature of such situations. The Enron Chapter 11 reorganization filed December 2, 2001, was then the largest bankruptcy in U.S. history – $62.8 billion in reported assets, not quite double the

previous record in 1987 by Texaco at $35.9 billion in reported assets (CNN, 2002b). Many Enron employees lost their jobs and also virtually every-thing invested through individual 401(k) retirement plans in Enron stock (CNN, 2002b). Many employees had invested most of their 401(k) holdings in the company's stock. It has been charged that 29 officers and directors of Enron sold about $1.1 billion in Enron stock during the period in which accounting reports were being manipulated (CNN, 2002b). Approximately 1 year before the bankruptcy, 62% of the 401(k) balances were invested in Enron stock (CNN, 2002a). About 11% of the 401(k) balances were restricted from sale as company matches on employee contributions; the rest of the balances were employee voluntary contributions not restricted from sale (CNN, 2002a). Enron stock dropped from above $80 per share in January 2001 to under $1 (CNN, 2002a). During October 26 to November 8, 2001, Enron blocked 401(k) sales as the stock fell from $15.40 to just over $9 (CNN, 2002a).

In January 2002, Aetna Inc. began phasing out health care benefits for newly retiring workers. The stated reason was cost reduction to remain competitive. Schultz and Francis (2004) report that one reason firms reduce retirees' health benefits is that the action creates income under accounting rules over and above direct savings. What happens is a reduction in an existing liability for future health care benefits that generates an immediate accounting gain, whether flowing immediately to the bottom line or taken annually. In the early 1990s, companies (e.g., Coca-Cola, ConocoPhillips, and Delta Air Lines) set caps on retiree health care (e.g., fixed annual amount per individual, per-retiree average, or fixed group sum). International Paper Co. recorded a $405 million liability at the end of 1991 for retiree health coverage. In 1992, the firm capped; the cap created a $133 million pool of accounting gains, of which $18 million flowed to 1992 income. Over 1993–1999, $17.7 million annually flowed to income, exhausting the pool. During 2000–2002, various benefit changes, such as caps for plans at newly acquired companies, replenished a pool of accounting gains, and over 2000–2003 $65 million flowed to income. An Ad Hoc Coalition to Restore Retirement Security (2004) release quoted a company spokesperson as confirming these figures; and stating they reflect standard accounting practices and that International "simply made plan design changes as part of our focus on controlling our costs while maintaining a competitive benefits program."

The Ad Hoc Coalition (Ad Hoc to Restore Retirement Security, 2004) alleged the following complaints concerning specific companies. (a) AT&T switched to a cash balance pension plan that increased its earnings while significantly reducing the expected pensions of salaried employees. The coalition proposed that legislation give employees the choice at retirement between promised pensions and any changes. (b) Halliburton sold its Dresser-Rand division and through a legal "loophole" shifted pension funds into a plan for

Halliburton employees. The coalition proposed that legislation prevent this maneuver. (c) Allstate reclassified thousands of insurance agents approaching eligibility for promised early retirement pensions as independent contractors and increased its earnings while reducing the agents' anticipated benefits to a small fraction. The affected agents sued. The coalition proposed that legislation restore full benefits. (d) General Motors (GM) informed thousands of early retirement package retirees "fine print" permitted GM to reduce or cancel promised lifetime health insurance coverage. The coalition proposed that such changes be made illegal. (e) WorldCom employees alleged that company officials told them to invest 401(k) money in company stock while those officials were secretly selling their own holdings. The coalition proposed that employees receive full remedies of misrepresentation.

Difficulties are particularly marked in certain industries such as airlines (Windsor, 1989) and steel (AP, 2004). These two industry situations reflect post-9/11/2001 conditions on the one hand (airlines), and intense international competition on the other hand (steel). Continental Airlines asked employees to accept significant wage cuts and benefit reductions; more than $1.1 billion in other cost cuts had been made (Hensel, 2004). The United Airlines bankruptcy reorganization illustrates the situation of persistent losses due to adverse industry and/or company conditions. Employee ownership fell from 55% to below 20% as part of reorganization. United Airlines (a unit of UAL Corp.), under bankruptcy protection, will terminate employee pension plans and replace them with less expensive retirement benefits; the firm needs to cut more than $1 billion in spending beyond the nearly $4 billion in savings for the proposed change in pension plans (*Houston Chronicle*, 2004d). Following 9/11/2001, in keeping with much of the U.S. airline industry, United fell on even more difficult circumstances. Net income (at December 31) was $1.235 billion for 1999 but only $50 million for 2000. Annual loss was $2.145 billion for 2001, $3.212 billion for 2002, and $2.808 billion for 2003 – on steadily declining revenues. Significant quarterly losses continued into 2004.

There has also been general pressure on firms due to falling interest rates. Firms must invest in their pension plans based on rate of return expected from 30-year Treasury bonds, no longer issued from 2001. Fortune 1000 companies had to increase contributions from $11 billion in 1999 to $44 billion in 2002 (Abrams, 2004). On top of this problem layers continuously rising health costs. Company self-insured or partially self-insured health plans cover more than half of all insured U.S. workers according to a Kaiser Family Foundation study (McKay, 2005). Self-insurance leaves workers unprotected in the event of company bankruptcy. The affected employees become creditors (McKay, 2005). ERISA regulates self-insured health plans and company officials can face prison time. In 2004, the U.S. Department of Labor closed 2,939 civil cases and brought 137 criminal cases; the latter recovered $10.6 million (McKay, 2005).

As of the end of 2004, PBGC was operating at a reported $23 billion deficit in excess liabilities (Carpenter, 2004). Additionally, PBGC assumed responsibility on December 30, 2004, for the pensions of United Airlines' pilots (more than 14,000 active and retired personnel) as the firm, in bankruptcy, eliminated defined-benefit plans for employees: the responsibility was estimated at about $1.4 billion in under-funded assets. The assumption was the third largest claim in PBGC history. PBGC was due to take over United Airlines' pension plans during 2005. By acting in December 2004 rather than waiting until May 2005, when pilots' pensions would be terminated, PBGC avoided the annual increase in mandated benefit payments and thus saved up to $140 million in additional payouts (Carpenter, 2004). Should public policy assume the higher cost level by waiting? In this instance, PBGC acts as if a business. A low risk of failure of retirement benefits would be borne adequately by the PBGC. Where firm bankruptcy becomes considerably more than a rare event – and particularly where concentrated in one or more labor-intensive industries – the key assumption generating the rules of the game fails. The risk may overwhelm PBGC. This situation bears an uncomfortable parallel with the savings and loan debacle of the 1980s (Bodie, 1996). PBGC insures private pensions of 44.4 million workers. PBGC deficit doubled in 2004 to $23.3 billion (AP, 2004).

Key Ethical and Social Issues

The inquiry here deals with one-sided changes to an existing plan and not to proper level of any plan. Proper level, like enforcement, is more a question in public policy than in normative ethics, although the latter may influence public policy. Corporate retirement plans are "negotiated" between firm and employee in sense of offer and acceptance, reflecting market forces. In theory, a firm might promise high compensation and/or possible bonuses and/or prospect of rising stock value (price and dividends) without immediate or retirement benefits of any kind. Every employee accepts or declines a specific package. Both degree of monopoly (offer) and monopsony (acceptance) power affect contracting. In practice, firms offer varying mixes of promised compensation, possible bonuses, immediate benefits, stock appreciation, likely severances, and retirement security plans. It is not possible theoretically to specify the proper level or composition of market-determined contracts. There are ethical and public policy issues concerning minimum and excessive compensation levels, access to employment and employment security, work conditions, and so forth. But this chapter addresses only changes to existing plans, whatever their circumstances. These circumstances are generally left to public policy. Much of compensation practice is simply implicit promises.

The value of the initial offer to any prospective employee is subject to current market conditions. These conditions may change radically in the

future without much controllability (Wernerfelt, 2004). Corporate retirement security programs are typically contingent promises only. Legal right of the offering party to change retirement terms without consent of the accepting party depends on exact terms of the initial employment contract and relevant laws. There may be conditions under which a contingent promise (which is not strictly an absolute guarantee) cannot be fulfilled of practical necessity. Business and bankruptcy laws recognize commercial impracticability. The promise is not automatically one of defined outcome (whether on contribution or benefit basis), but rather one of "caveat emptor" in this instance directed at the employee. The analysis of continuation of both present employment conditions and future retirement conditions is to this point strictly one of legal interpretation of contracts. Normative ethics implies rules and such rules are difficult to identify in this zero-sum game. The proposals of the Ad Hoc Coalition to Restore Retirement Security (2004) typically call for creating legal rules prohibiting or commanding specific actions. The rationales for these legal rule proposals should be implicit in moral principles.

"The guiding principle of good, fair employers should be to offer retirees reasonable, cost-effective choices on their benefits" (Hall, 2004). A principle is more flexible than a rule. Hall's proposed principle requires definitions of "good, fair," and "reasonable." Halliburton, which merged with Dresser in 1998, filed suit against 4,000 Dresser retirees, paying by law for their legal representation (*Houston Chronicle*, 2004a), to terminate their health insurance coverage (*Houston Chronicle*, 2004b). A federal district court ruled that Halliburton cannot change that coverage without doing so for all other employees (*Houston Chronicle*, 2004b); and that Halliburton had agreed to provide lifetime benefits for Dresser retirees (*Houston Chronicle*, 2004a). While considering whether to appeal, Halliburton announced that it would reinstate coverage for the Dresser retirees and take a $13 million pre-tax charge for current and future retiree medical costs (*Houston Chronicle*, 2004b). The court invoked a rule. An editorial comment that "... pulling the rug out from under retirees is not good corporate citizenship" (*Houston Chronicle*, 2004a). Halliburton's conduct tested a rule and violated a principle.

For present purposes, law is a set of rules and ethics is a set of principles (and values). Dworkin (1978, pp. 24–28) draws a logical distinction between rules and principles as different kinds of standards. "Rules are applicable in an all-or-nothing fashion. If the facts a rule stipulates are given, then either the rule is valid, in which case the answer it supplies must be accepted, or it is not, in which case it contributes nothing to the decision" (Dworkin, 1978, p. 24). A rule takes the form of a specific prohibition (i.e., X is forbidden) or commandment (i.e., X is required). Any action falling outside the conditions of the rule is voluntary: neither prohibited nor commanded. For example, in baseball, the rule is that a batter with three strikes is out (Dworkin, 1978, p. 24); out is

the consequence of the conditions and the rule. A rule may have exceptions: a batter is not out on the third strike if the catcher drops the ball, but this exception can be listed as part of the most accurate rule (Dworkin, 1978, pp. 24–25). In contrast, a principle does not set out the "... consequences that follow automatically when the conditions provided are met" (Dworkin, 1978, p. 25). While the "... law respects the principle that no man may profit from his own wrong ... we do not mean that the law never permits a man to profit from wrongs he commits. In fact, people often profit, perfectly legally, from their legal wrongs" (Dworkin, 1978, p. 25). For example, persistent trespass may result in rights through "adverse possession" (Dworkin, 1978, p. 25). "All that is meant, when we say that a particular principle is a principle of our law, is that the principle is one which officials must take into account, if it is relevant, as a consideration inclining in one direction or another" (Dworkin, 1978, p. 26). Principles thus have "... the dimension of weight or importance" so that in conflict of principles "... one who must resolve the conflict has to take into account the relative weight of each" without "exact measurement" (Dworkin, 1978, p. 26). A principle takes the form of a general injunction: X is right or X is wrong. The principle is binding unless there is a conflicting principle affecting X. "If two rules conflict, one of them cannot be a valid rule" (Dworkin, 1978, p. 27). A rule is "absolute" and a principle is "relative" (Dworkin, 1978, p. 27).

Given legal permissibility, an ethical issue means that the change can and should be questioned in principle independently of the legal rules or practicalities. A social issue means that the general public (i.e., society and government acting through public policy) becomes involved either through costly adjudication, or the argued need to change existing legal rules in favor of employees and/or retirees, or the actual or argued need to absorb on behalf of employees and/or retirees the costs of the adverse effects in lieu of changing existing legal rules.

Ethical and social issues can arise either due to non-compliance of changes with law (criminal or civil) or in connection with legally permissible changes. The focus in this chapter is on legally permissible changes made unilaterally to corporate retirement programs or required or caused by the company (i.e., management acting under authority of the investors) that have adverse effects on the perceived or actual welfare of employees and/or retirees. These changes violate employee and/or retiree "expectation" (i.e., "psychological contract") concerning retirement benefits. An "expectation" reflects an implicit promise or obligation not legally binding. A "promise" is something (allegedly) communicated by the company; an obligation is something (allegedly) incumbent on the company, even if not promised. A promise amounting to a legally binding contract means there is an enforceable legal rule concerning implementation of the promise. Otherwise there are differences between promises and contracts. An expectation amounting to an inducement without guarantee

should be met unless there is sufficient good reason not to do so. "Unilateral" means that the change is made directly by and for the benefit of the company without concurrence of affected employees or retirees. "Required" means that the company demands that employees and/or retirees concur with the proposed changes and has the power to compel concurrence which would not be given voluntarily. "Caused" means that some action of the company undertaken with or without concurrence of employees or retirees results in the changes, intentionally or inadvertently. "Legally permissible" means that one or more of statutory law, regulation, or contract law permits the company to make, require, or cause the change. Legal "permission" in this context can come in three suspect forms: "loophole" (i.e., a means of evading an obligation) or "fine print" (i.e., very small print for exceptions or permissions to an obligation typically not read by the injured party) or deterring cost of legal action for redress by the injured party. Civil lawsuits may not function well to deter misconduct by businesses (Haar, 1995). For example, there is empirical evidence to suggest that the stronger the corporate governance (i.e., theoretically investor influence), the more likely it is that business executives choose to litigate rather than settle civil lawsuits regardless of potential loss to the firm (Haslem, 2003). The same problem presumably arises with criminal prosecution where enforcement is predicted to be lax. (Aviram, 2004, examines a debate over whether firms have perverse incentives to implement ineffective compliance programs.)

An employee or retiree has expectations concerning the future behavior of the firm that may be characterized as a "psychological contract." This one-sided "contract" is not legally defined or enforceable, and it may or may not have a moral basis. Rather, the employee or retiree expects the firm to do or not to do various things in the future. The firm may decide that it has an interest in affecting this psychological contract or not. One way of viewing such expectations is to posit that employees or retirees see the firm as "fair" if they cannot reject the hypothesis that the firm is benevolent toward them in at least some small degree. This approach is adapted from Rotemberg (2004), who characterizes "fair pricing" by the firm in terms of whether consumers can reject the hypothesis that the firm is somewhat benevolent toward them in its pricing behavior; that is, the firm does not fully exploit demand opportunities. The reason is that consumers who reject the fair pricing hypothesis become angry at the firm, and this anger is costly to the firm. Analogously, employees or retirees either see the firm as "fair" in compensation or retirement practices, respectively, or become angry at the firm if they reject the fair compensation or fair retirement hypothesis, respectively. Fair compensation or fair retirement means that the firm does not fully exploit cost-reduction opportunities. The difference is that the firm may care about the reaction of consumers (i.e., revenue opportunities) and not care about the reaction of employees and/or

retirees (i.e., reducible cost opportunities). Whether the firm cares about the reaction of the general public is a consideration in public policy.

The focus in this chapter is on the ethical and public policy dimensions of legally permissible changes from status quo expectations where such changes are adverse to the perceived or actual interests of employees and/or retirees. Voluntary concurrence (neither coerced nor manipulated) of affected employees or retirees implies that a change from the status quo is reasonably favorable to their perceived welfare. The setting is a zero-sum contest among investors, executives (i.e., the principal–agent problem), employees, and retirees for distribution of benefits and costs. The competition may be modeled as executives grouped with investors versus employees grouped with retirees; in this competition, employees face incentives to injure retirees. The relationship between management and labor involves cooperation for wealth creation and competition for rent appropriation. Wealth is jointly created. One may make a moral claim to a share in such wealth on this basis, but joint production notoriously cannot be allocated among participants. Retirees (i.e., past labor) are purely an expense item. They participated in past wealth creation, but have no role in current or future wealth creation.

The moral situation is a repetitive five-party game in which the rules are changing, in effect being renegotiated, due to self-interested actions of one party in light of changing conditions. The five parties to the "game" are current employees, investors, managers, retirees (former employees or their heirs), and the retirement guarantor (the government). The initial contract contingently promised employees that at retirement they would likely receive a stream of benefits. The contract is more psychological than ironclad. The government undertakes to guarantee a partial pension component; and undertakes some minimum income and health care guarantees in the form of earned social security payments. The assumption of the five-party game has been that firm default (i.e., inability to continue promised retirement benefits) – due largely to bankruptcy – is a reasonably rare event and randomly distributed across industries.

Retirees contribute no revenue to a firm, and are purely a cost element. Two different situations may arise. One situation can be characterized as necessity. A firm faces bankruptcy and the solution is reduction of cash outflows. Necessity defines morality. The standard is less one of group welfare than of who can generate revenue. In bankruptcy, retirees become just one category of creditor, and not first in line at law. Current employees have strong incentives to support harm to retirees (Strope, 2004). The contingent commitment was only to sharing of expected cash flows. The PBGC was set up, in theory, to address this necessity problem on a low-risk assumption. A return to profitability then implies however a return to ethical obligation to honor previous promises. Permanent disavowal despite improved conditions is suspect and transfers the burden to public policy. It may be difficult to sell a firm with

continuing obligations, but at least the vital question is then isolated for public policy consideration. The other situation can be characterized as pure managerial opportunism. Opportunism does violate ethics. One party figures out a way to appropriate expected cash flows upon a pretext. This situation could be a fall in expected cash flows not sufficient to trigger necessity but sufficient to create opportunity for appropriation through unilateral change in contract. This kind of opportunism, even if not a violation of law, is unethical and creates unanticipated risk to public policy, transferring financial burden to taxpayers and erosion of trust within society.

Conclusion

The on-going changes in corporate retirement programs suggest two empirical findings. One is that company executives are amoral, or acting under impulse of a strictly economic viewpoint. Another is that for businesses not to go beyond adherence to law, which the company seeks to undermine in any case, is not a sufficient safeguard of public interest. At the same time, each proposed change in public policy has to be weighed in terms of the pros and cons.

These changes occur within a broader context. Whitman (1999, p. 13) predicts that power will shift in coming years from employees (i.e., labor) to consumers (i.e., demand) and investors (i.e., capital). The Bush Administration has reportedly considered changing the conventional formula for setting initial Social Security benefits (Weisman & Allen, 2005). Historically first-year benefits for retirees have been calculated using the increase in wages over a worker's lifetime. A "price indexing" proposal would use instead inflation rates (i.e., purchasing power erosion), which increase much less than wages historically. The result would be a reduction in benefits "promised" under the wage approach by nearly a third due to the change in calculation method. Otherwise, Social Security tax rates must increase to cover liabilities for an increasing retired population and a decreasing employed population. Presumably some of the difference, if not all, would be made up by private investment accounts also being proposed by the Bush Administration. The change presumably will apply to future generations of retirees at some point after private investment accounts are operating. The public policy problem going far beyond managerial opportunism is that U.S. employment and labor compensation could decline due to rising energy prices and increasing international competition from countries such as China and India. (The same might occur in Western Europe with respect to Eastern Europe.) Samuelson (2004) argues that it is by no means certain in economic theory that dynamics of comparative advantage must benefit presently advanced economies as other countries develop and enter the global economy.

The vital issue is what ethical principle(s) should govern in such a game. There are three general approaches to criticism of opportunistic company

conduct. Ethics and normative stakeholder theory argue that the company's implicit promise is a moral commitment that should be honored. Necessity but not opportunism may be weighed against this principle. Corporate social responsibility and descriptive stakeholder theory argue that the company should consider the social impacts of its conduct. Public policy has to absorb the repercussions of company actions. It is a bad development that companies defer difficulties to public policy and erode trust in doing so. Instrumental stakeholder theory argues that a company's reputation may be damaged, and that stakeholders may find sufficient power to harm a company.

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8

Reflections on Markets, Retirement, and Corporate Responsibility

Jeffery Smith

Reflections on Markets, Retirement, and Corporation Responsibility

One overarching problem with retirement in general, and pension benefits in particular, is that securing income for ten, twenty, or thirty years into the future, while maintaining the trust implicit in many retirement programs, is a terribly complex proposition. Eugene Heath's astute observation that market mechanisms ought to *guide* how retirement income is secured is important advice for the reasons he suggests; however, the complexity involved in the adequate implementation is that any such market-guided arrangement is something that cannot be underestimated. It is this complexity, at bottom, that raises the multi-layered concerns advanced by Heath, Duane Windsor, Michael Johnson-Cramer, and Robert Phillips regarding the values of justice, fairness, wealth, and individual responsibility.

The following remarks will focus not simply on the features that complicate a sound system of retirement security. Time will also be devoted to explaining why this complexity is an argument for coordination and oversight in securing retirement income for current employees. Such coordination and oversight can occur to varying degrees within many different institutions, both public and private. While no comprehensive reforms or policy initiatives are inferred from the defense of this observation, a general point about the ability of individual choice to be the sole arbiter of retirement security will be drawn. In addition to these considerations, brief mention will be made, too, of the extent to which corporations, as opposed to governments, ought to shoulder the burden of securing retirement income. Heath is correct that there should be no presumption made either way; nonetheless, the need for coordination and oversight in retirement planning necessitates that the decisions of individual employees be tied to institutions that absorb risks and channel information appropriately.

Retirement Complexities

Windsor's discussion of the changing nature of the employee–employer relationship illustrates a number of basic challenges facing employees within the current labor market. Among these challenges is retirement income security. Corporations are legitimately concerned that the costs associated with pensions are weakening their financial position. Indeed they sometimes have good reasons for changing or otherwise reducing the benefits associated with their pension programs: bankruptcy, foreign competition (as in the case of the automotive industry) and, according to Johnson-Cramer and Phillips, the need to balance other legitimate stakeholder interests. Other times, however, it is less clear that the necessity to restructure pension benefits is the result of market uncertainty and competition; in some noteworthy cases managers have acted opportunistically and neglected pension funding in favor of other near term goals. Even healthy firms have made decisions to scale back pension offerings and retirement benefits (Walsh, 2006).

Heath, Johnson-Cramer, and Phillips rightly point out that part of this problem is attributable to the conflicting messages and inducements created by law. Defined benefit pension plans were in large part created when federal government offered tax benefits to corporations that assumed financial liability for their employees' future income. What some might consider the direct responsibility of government (i.e., retirement security), was implicitly relegated to corporations. A series of efforts on the part of the federal government to limit revenue shortfalls, however, lead to significant reductions in the corporate tax benefits attributable to pension funding. Plans that have long been in existence have begun to experience shortfalls as the incentive to adequately fund pension plans was eliminated in the 1980s and 1990s through complete reversals in the tax code (Kotlikoff and Smith, 1984; Mitchell and Smetters, 2004).

There were, to be sure, other forces at work in the early development of defined benefit pension plans. Corporations did see their creation as something to both attract workers and improve retention. Labor unions did exert influence in their creation as increases in other forms of compensation were not attainable. Nonetheless, it does seem that current market realities do not bode well for the continuation of defined benefit pension plans. The available incentives to maintain these plans are simply not strong enough to counteract the short and intermediate term costs associated with competing in a global environment with multiple labor and industrial markets (Walsh, 2006). Any act by the federal government to either assume future pension funding or guarantee existing pension liabilities is extremely costly to say the least (U.S. House Education and Workforce Committee, 2003).

These historical, legal, and economic facts demonstrate some of the complexities alluded to in the opening paragraph of this discussion. It is important

for observers to note, however, that a retirement system predicated on individual choice and wealth management does not eliminate other obvious forms of complexity that impact the ability of individuals to adequately save for retirement. These other complications should temper any quick call for a transition to a system of retirement security exclusively patterned after existing defined contribution plans. This is not to say that such plans are fundamentally ill conceived; rather, it is a warning to policy makers that wish to emphasize pension portability, individual choice and even, following Heath, responsibility over the economic risks associated with defined contribution plans (Kronson, 2000).

First, individual employees, as a general rule, do not engage in the risk assessments, information gathering, and disciplined behavior needed to make prudent investment choices (U.S. Department of Labor, 2001). There are clear strategies to employ depending upon the time before retirement, the possibility of reversals in historical patterns of performance for types of investments and other macroeconomic trends that impact the value of one's savings. There is evidence to suggest that these kinds of variables make little difference in savings and investment for large segments of the population.

Consider that many individuals neither seek out basic information regarding their retirement income nor adjust their savings rate according to such information. Over a third of current works plan to retire before 65 and yet their savings rate does not reflect this choice. Almost 20% of workers operate under the dubious assumption that they will only need 50% of their current income in retirement. Savings rates are frighteningly low: 15% of the working population in the United States has no savings for retirement and almost half of all workers have less than $50,000 in savings. Only a third of current workers have actually engaged in a rigorous calculation and assessment of their retirement needs (Employee Benefits Research Institute, 2002).

Second, apart from the motivation and skill of individual workers to plan for retirement, it is not obvious that sufficient information is available for individuals to make well-informed choices about their retirement income. Many well-trained investment strategists quoted in the pages of prominent periodicals will disagree about the near term performance of the stock market. This may make a significant difference for someone nearing a 7 year time frame before retirement. There are also distortions and asymmetries in information. Many defined contribution plans have employer matching contributions in the form of company stock. The guidance that employees receive about the value of this match is inevitably shaped by forces (i.e., company officials or research firms with links to investment bankers), that seek to cast the company's performance in a positive light. This has lead to situations of great risk to employees when the stock price of their employer's company has fallen. It is unclear, too, that firms that manage individual retirement savings are inclined to present the timeliest information regarding a particular

investment vehicle. It is perhaps unfortunate that individuals, as a matter of practice, rely on investment firms for advice and direction because such firms possess information that the typical investor does not have the ability, time, or expertise to effectively use (Kronson, 2000).

A final element of complexity ties loosely to the problem identified by Johnson-Cramer and Phillips and the general problem of how social contracts are subject to economic constraints. There are ample cases where employees have little, if any, input into the structure of their retirement savings plan. Heath's freer, more deliberative labor market should (ideally) review the terms and conditions of retirement so long as there are relevant preferences for that form of compensation. But adding employee involvement in the creation and development of retirement compensation is certainly part of what makes pension management so difficult. Which employees are covered and at what point? Do we grandfather certain employees under a previous plan in order maintain the implied promise of a defined benefit? Should retirement automatically be a matter negotiated by collective bargaining units? Or should compensation be offered in place of retirement benefits? How should this compensation be calculated? The risks and uncertainties discussed above make it unlikely that these questions could be set aside easily. Individuals may have difficultly saving and investing; however, they are well aware of the need to have a conversation about income in their retirement years.

Individual Responsibility

Out of this complexity Heath argues that there should be a presumption in favor of solutions to retirement security framed by the decisions of individuals in the market. Many of the problems regarding the apparent inability of individuals to save for retirement might, once and for all, be dealt with by a system that instilled *responsible* behavior among the current working population. This yields a correlative presumption in favor of defined contribution-style pension programs.

Heath's notion of individual responsibility involves a sophisticated mix of motives, skills, and virtues having to do with self-control, temperance, and diligence. Like Aristotle, however, individual responsibility is something that emerges from well-developed social practices where responsible behavior is exemplified and trained. In the case of retirement planning this rings true. It might well be said that the individuals profiled above, who fail to take the appropriate steps to secure their own retirement income, exhibit a lack of responsibility. Yet it is difficult to uniformly assert that what is needed to instill responsibility is full, independent control over one's retirement savings and exposure to the risks of failure that come with a defined contribution plan.

Responsibility is not firmly taking hold even for those who have had the discretion advocated by Heath for their entire working lives. The inculcation of responsibility would appear to require much more, including, among other things, sufficient income to make wise choices about the future and a comprehensive sense of the future duties to oneself and others. On this, Heath may concur.

Part of being responsible involves an understanding of one's own strengths, weaknesses, limitations, and weighted preferences. It also involves acting according to a plan that addresses these facts. There is nothing inherently less responsible in delegating my retirement savings plan to an agent that is believed to be reliable and for whom it can be said that they will achieve certain outcomes that I cannot achieve on my own. There is also nothing less responsible in making the determination that lower rates of return are an acceptable trade off for the increased stability that may come through the corporate management of a pension fund. There is nothing, in short, in the nature of the defined benefit plan that engenders less individual responsibility. Heath provides no evidence that current retirees, having spent their entire working lives covered by a defined benefit plan, have exerted less effort, shown less care for the well-being of their families, and been exposed to fewer foresight-enabling risks.

The choice of what kind of pension plan to prefer is, thus, not answered by what promotes individual responsibility. The mechanisms of the market have in many ways already answered that question for us. Some policy makers have begun to recognize that the risks of planning for retirement cannot be reasonably borne by individuals; at the same time, it appears to economically unsustainable for corporations to shoulder the same burden. This had lead to an interesting array of suggestions regarding the future of defined contribution plans: asset diversification requirements, rigorous fund disclosure statements, minimum employee contributions, regulations on the asset composition of employer contributions, and the like. These efforts balance the need to share risks while placing key decisions about retirement income in the hands of individuals (Retirement Solutions Foundation, n.d.; Kronson, 2000; Mitchell and Smetters, 2004).

Coordination and Oversight in Retirement Planning

Heath also takes the complexity discussed thus far to be an argument for "decentralized decision making and experimentation" and, hence, broader exposure to market mechanisms when it comes to retirement benefits and saving. There are rehearsed failures of the market, however, that demand the just the opposite. Whenever there are undue social costs or insufficient information, there are legitimate calls for coordination by actors that can produce

more desirable results than the market can alone. This need not always entail the intervention of government; corporations themselves can be viewed as institutions that beneficially respond to the inefficiencies and transaction costs associated with free exchange.

How we configure the system of retirement security is an empirical matter, hardly to be decided *solely* on the basis of individual choice, corporate guarantee, or government mandate (Modigliani and Muralidhar, 2004). Incentives for savings rates that sufficiently reflect foreseeable risks need to be established. The competitive position of corporations should indeed drive decisions about how much risk they should bear and how they might be compensated. Sound policy should attempt to insure pension savings, whether through defined benefit or defined benefit approaches. Individuals, corporations, and public agencies are involved in all of these aspects. Participation by employees in the market (per Heath), within corporations (per Johnson-Cramer and Phillips), and indirectly in the political process are therefore integral to any well-developed system of retirement income.

Managing the social good of retirement is complex because there are economic constraints to fulfilling social expectations and contracts that emerge in the labor market. Whatever arrangement of programs, practices, and policies emerges from the current debate, it needs to be clearly stated at the outset that retirement security is an important social good, even in a liberal society that avoids preferring one way of life over another. Any well-developed life plan needs a provision against poverty and an assurance of autonomy that comes with retirement income security (Galston, 1991). In this regard, retirement income is much like the good of health care. Risks need to be shared and unforeseen individual circumstances need insurance against misery. Just as an individual needs the oversight and coordination provided by doctors, health care organizations, and insurers, future retirees can gain from independent wealth management firms and a reformed Pension Benefit Guarantee Corporation (PBGC). And, just any one individual is ultimately responsible for lifestyle choices that affect their health, future retirees are responsible for making decisions that accord with their future plans. The right mix of regulations and incentives to achieve this vision is something for labor economists to continue to pursue.

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Part III

Investing Pension Plan Funds

The three chapters in this section speak to the appropriate investment policies of pension funds with respect to the issues of *socially responsible investing* (*SRI*). "SRI" is a term that has been created, with obvious polemical overtones, to describe and advocate an attention to values other than risk and return in investment choices. The majority of the "SRI" community advocates investment policies that are pro-environment, anti-defense, anti-tobacco, anti-alcohol, and pro-gay. A smaller segment of the SRI community advocates religiously based investing and anti-contraceptive and anti-abortion/pro-life investing.

The key question for corporate retirement security is whether investment policies should focus only on risk and return, or whether considerations of social responsibility (however conceived) should guide the investment choices of those who manage pension funds. If socially responsible considerations are appropriate, then the giant question becomes: "*What values* and *whose values* should guide investment policy?" For here the problem is that the pension fund manager works on behalf of a multitude of fund beneficiaries with certainly diverse and conflicting conceptions of what sort of investments actually *are* socially responsible.

In his chapter, "Pensions and the Companies They Own: Fiduciary Duties in a Changing Social Environment," Peter D. Kinder argues that policies recently enacted by the Securities and Exchange Commission have altered the fiduciary duties of those managing assets on behalf of others and that these new policies will come to govern all such fiduciaries, pensions included, whether or not they are subject to the SEC's jurisdiction. According to Kinder: "The revised standard will require fiduciaries to factor into their judgments social and corporate responsibility issues … The new approach to fiduciary responsibility will force pensions to examine the meaning of "ownership" in the context of shares in corporations. It will compel pensions to address their dual roles as guarantors of benefits and as financial institutions, and finally to redefine their relationship to our economic and political systems." If Kinder is correct, this will imply an abandonment of a focus on just risk and return.

In contrast to Kinder, Sarah Fuhrmann believes that the path toward SRI and "corporate social responsibility" (CSR) for pension funds is fraught with danger, as she argues in her contribution: "Pension Funds and Socially Responsible Investing: More Risky Than Responsible Business." She sees the

SRI industry as being largely absorbed with self-promotion and the advancement of its own commercial interests, and she finds growing resistance to this self-aggrandizement that she sees. As a result, she concludes: "Given this environment, it remains questionable whether corporate and related pension funds … often themselves the targets of pressure from CSR/SRI groups – should leverage their significant financial power to become involved in the CSR/SRI fray."

Jon Entine is even more strongly opposed to the CSR/SRI influence on pension fund investing, as he strongly argues in "Why Social Investing Threatens Public Employee Pension Funds." Entine believes that some who manage pension funds "… see themselves as agents of social, environmental, and economic change, incorporating controversial and fungible social criteria into their investment decision process." He believes that some of these forays in determining investment policy have generated substantial losses and that they are seldom effective in achieving the social change that such socially active managers pursue in any event. While Entine appears to concede that the law allows sufficient latitude to make such policies permissible, such policies constitute, in his view, "a dalliance that should be avoided."

9

Pensions and the Companies They Own: New Fiduciary Duties in a Changing Social Environment

Peter D. Kinder

> *I would like to warn the gentlemen of the City and High Finance that if they do not listen in time to the voice of reason their days may be numbered. I speak to this great city as Jonah spoke to Nineveh.… I prophesy that unless they embrace wisdom in good time, the system upon which they live will work so very ill that they will be overwhelmed by irresistible things which they will hate much more than the mild and limited remedies offered them now.*
>
> John Maynard Keynes (1923).[1]
>
> *On the new Wall Street, everything occurs out in the open. Any financial system based on the stock market is bound to be as transparent as the old bank-based system was opaque, so that it is fitting that asset managers operate in glass skyscrapers.*
>
> Ron Chernow (1997).[2]

This chapter argues that the U.S. Securities and Exchange Commission (SEC) has altered the fiduciary duties of those holding stock on others' behalf. That redefinition will become the rule for all fiduciaries, pensions[3] included, whether or not they are subject to the SEC's jurisdiction.

The revised standard will require fiduciaries to factor into their judgments social and corporate responsibility issues. In framing their new regulations,

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Dedication: This chapter is dedicated to the memory of William J. Brown, Attorney General of Ohio, 1971–1983, who believed the duties of trustees should be enforced and devoted the staff and political capital required to regulate charitable trusts. As the years pass, it becomes ever more clear what a privilege it was to work for him.

[1] Robert Skidelsky, *John Maynard Keynes: The Economist as Saviour*. (1992), New York: Penguin Books, 1995, p. 131.

[2] Ron Chernow, (1997). *The Death of the Banker*. New York: Vintage, p. 81.

[3] By "pensions", I mean defined benefit plans, in particular, those sponsored by government units. Different rules apply to defined contribution plans which ease the inclusion of socially-screened options in diversified offerings. Here, I will only deal with defined benefit plans.

the SEC drew on the experience of the socially screened mutual funds. Their experience and tools offer a framework for implementing the new responsibilities. The Appendix to this paper describes the trust law context in which pensions operate and the SEC recast trustee obligations.

The new approach to fiduciary responsibility will force pensions to examine the meaning of "ownership" in the context of shares in corporations. It will compel pensions to address their dual roles as guarantors of benefits and as financial institutions, and finally to redefine their relationship to our economic and political systems.

The next 20 years promise to be interesting times for pensions.

Introduction

> *The theory of representation, whether in politics or in business, is of the essence of modern development. Our whole system rests upon the sanctity of the fiduciary relations. Whoever betrays them, a director of a railroad no less than a member of Congress or the trustee of an orphans' asylum, is the common enemy of every man, woman, and child who lives under representative government.*
>
> Charles Francis Adams Jr. (1869).[4]

Law students learn that the Securities Acts of 1933 and 1934 work because they rely on corporate disclosure enforced, primarily, by private actions. They do not, typically, learn that disclosure also shored up the legitimacy of the securities industry and, indeed, the American capitalist system itself which the 1929 Crash and the subsequent Great Depression had called into question.

The Acts' proponents knew what they proposed to remedy. Future House Speaker Sam Rayburn (D-Tex.) put it perfectly when he said the 1933 Act "is not so much a response to the frauds of criminals as it is to the reticence of financiers."[5] The U.S. SEC, better than most administrative agencies, has stuck to its founding principles. Its 2003 proxy voting regulations, requiring mutual funds and advisers to disclose their policies and votes, attack a profound reticence in the financial services industry and among pension funds.

Transparency

> *The time is coming when all business will have to be done with glass pockets.*
>
> J. Pierpont Morgan (1913).[6]

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[4] Adams Jr., C. F. (1869). A Chapter of Erie, as reprinted in Adams Jr., C. F., & Henry Adams, *Chapters of Erie and Other Essays* (1871) New York: Augustus M. Kelley, 1967, p. 8.

[5] McCraw, T. K. (1984). *Prophets of Regulation* (p. 173). Cambridge, MA: Belknap/Harvard University Press.

[6] Chernow, R. (1990). *The House of Morgan* (p. 157). New York: Atlantic Monthly.

For pensions in 2005, the word *du jour*, “transparency”, applies both to their actions and those of the companies they own. Their legitimacy – the pensions’ and the companies’ – and that of our financial system are at stake.

Today, the financial transparency[7] required by the Securities Acts marks only a starting point for pension and corporate reporting. Some corporate activities and, therefore, pension-fund investments have social and environmental effects that do not yield to ready quantification.[8] Contributions to global warming is one of these. Still, they may affect investment performance – especially over the long term – as profoundly as currently quantifiable and measurable criteria.

Pensions have, as a rule, ignored non-financial factors, a category to which they have consigned social and corporate responsibility issues. That will change; perhaps it has already changed with the evolution of the concept of fiduciary duties.

SRI’s Contribution

SRI offers pensions a vital tool for meeting this new obligation. The framework, research, and benchmarks developed over the last 35 years provide a structure and a context for monitoring corporate activities which both corporations and the institutional investors have accepted.

In part because of their experience during the South African years, pensions have avoided social investing. They can no longer do so.

Their broad ownership of common stock makes the pensions an integral part of the network of fiduciary relationships that bind together the American economic system. As such, they not only represent the interests of their beneficiaries but of a much broader group of stakeholders. While their primary duties run to their beneficiaries, they also owe a duty to the entities that established them for the social good.

This chapter explores how pensions may fulfill that duty.

The SEC’s New Fiduciary Standard

> Where stock is held by a great number, what is anybody’s business is nobody’s business.
>
> Andrew Carnegie (1900).[9]

[7] “Transparency” is the “word that the big shots use when they mean ‘honesty’ but just can’t get it out of their mouths.” von Hoffman, N. (2002). Flimflam finances spell trouble for pitt. *New York Observer*, June 24, p. 4.

[8] Many social and environmental issues have quantifiable costs associated with them, as employment practices do. The standards applied in these areas evolve. Even the most forward looking employment policies of 1964 would probably be actionable today.

[9] Micklethwait, J., & Wooldridge, A. (2003). *The Company: A Short History of a Revolutionary Idea* (p. 74). London: Weidenfeld & Nicolson.

One hundred and seventy-four years ago in *Harvard College v. Amory*, the Supreme Judicial Court of Massachusetts stated what is now called "the prudent investor rule" for trustees. Trustees should model their stewardship on:

> how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.[10]

Not the least reason for this rule's durability lies in its flexibility, in its assumption that trustees would apply their "prudence, discretion, and intelligence" to the facts available about an investment.[11] The practical definitions of those terms change over time. Because of the flexibility of these concepts, the rule has endured as the nature and scope of knowledge about particular types of investments has evolved and expanded.[12] Just as the concept of fiduciary duty itself has.

One question before the court in *Harvard College v. Amory* was whether prudent trustees could invest in what was then a relative novelty: common stock. Could the trustees know enough about the ventures to make them appropriate for a trust to benefit a widow and the residuary beneficiaries? The court held they could.

Pensions now confront questions about issues of governance, social effects, and sustainability[13] posed by the companies they own – corporations vastly larger, far more complex than even the most far-sighted could imagine in 1831.

And, pensions must now gauge their fiduciary duties in a new context, one set out by the SEC in 2003. For in answer to Andrew Carnegie, the SEC has decided that what is anybody's business is everybody's business.

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[10] *Harvard College v. Amory*, 9 Pick. (26 Mass.) 446, 461 (1831). *Cf.* Uniform Prudent Investor Act (1994) Section 2 which restates the rule, clumsily, and omits both the negative reference to speculation and the explicit admonition to manage for the long term.

[11] The Reporter for the *Restatement (Third) of Trusts* characterizes the rule as "dicta". *Restatement (Third) of Trusts* Section 227 Gen. Notes, p. 58 (1991). If so (and the point is arguable), it is another example of a judicial aside outstripping the importance of the case itself. Virtually no one today knows what the "prudent man" case was about, much less its outcome. And, it was very important to its time. That lesson should be kept in mind when considering the importance to trustees of the SEC's rationale for its proxy voting regulations.

[12] Prof. C. E. Rounds Jr. pointed out to me that *Harvard College v. Amory* had nothing to do with social investing. He is correct. My point, however, is that the court did not limit to financial data the scope of the information trustees would bring to bear on a decision as to "the permanent disposition of their funds". As individuals, trustees would consider their own ages, the life-stages and needs of their family members, their familiarity with the subject of the potential investment and other, similar factors.

[13] *But compare* Uniform Prudent Investor Act Section 2(c) which lists only financial criteria which a trustee should consider. However, the Comment to that section (¶6) characterizes the list as "nonexclusive."

The 2003 Proxy Regulations

> [The securities laws must embody] the ancient truth that those who manage banks, corporations, and other agencies handling or using other people's money are trustees acting for others.
>
> Franklin D. Roosevelt (1933).[14]

On January 23, 2003, the U.S. SEC adopted regulations on proxy voting by mutual funds and investment advisers[15] based on a new elaboration of the concept of fiduciary duty.[16]

Responding to a petition by Domini Social Investments, LLC, the AFL-CIO, and the Teamsters Union, the Commission now requires mutual funds and investment advisers to:

- Disclose their policies and procedures for voting in corporate elections.
- Report how they actually voted on each issue at each company.

Until then, only some social mutual funds[17] and the California Public Employee Retirement System (CalPERS) had done this.[18]

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[14] Chernow, R. *The House of Morgan* op. cit., p. 378.

[15] SEC, "Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies" (January 31, 2003), 17 CFR Parts 239, 249, 270, and 274 [Release Nos. 33-8188, 34-47304, IC-25922; File No. S7-36-02], RIN 3235-AI64. http://www.sec.gov/rules/final/33-8188.htm (hereafter "Adviser Regulations"). And, Securities & Exchange Commission, "Proxy Voting by Investment Advisers" (January 31, 2003), 17 CFR Part 275 [Release No. IA-2106; File No. S7-38-02], RIN 3235-AI65 http://www.sec.gov/rules/final/ia-2106.htm (hereafter "Mutual Fund Regulations"). For a discussion of the regulations and their importance, see "KLD Newsline", April 2003 http://www.kld.com/newsletter/archive/april092003.htm

[16] It is the SEC's expansion of the concept that is novel and important. At least as early as 1994, the U.S. DoL was telling ERISA and Taft-Hartley plans, "In general, the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock. For example, it is the department's position that the decision as to how proxies should be voted with regard to the issues presented by the fact pattern are fiduciary acts of plan asset management. …" "The Avon Letter", February 23, 1994. http://www.lens-library.com/info/dolavon.html. To the same effect, see "Interpretive bulletin relating to written statements of investment policy, including proxy voting policy or guidelines", 29 CFR Section 2509.94-2(1) (hereafter "DOL *Interpretive Bulletin 94-2*") http://www.dol.gov/dol/allcfr/Title_29/Part_2509/29CFR2509.94-2.htm

[17] The Domini Social Equity Fund was the first mutual fund to publish (in 1992) its proxy voting guidelines and to report its votes. In 1999, it was the only mutual fund cited as reporting proxy votes by SEC Commissioner Paul R. Carey in a speech to the leading industry trade group. Paul R. Carey, "Remarks to the Investment Company Institute Procedures Conference", December 9, 1999. http://www.sec.gov/news/speech/speecharchive/1999/spch335.htm. KLD prepared the first set of guidelines and remained involved in their annual iterations through 2006 http://www.domini.com/shareholder-advocacy/Proxy-Voting/index.htm

[18] One reviewer of this paper suggested that public pension votes would be available through a state freedom of information act-type request. For a successful example of such a request in New York, see Wayne Barrett & Emily Weinstein, Carl McCall's secret self. *Village Voice*, August 21, 2002 http://www.villagevoice.com/issues/0234/barrett.php

The new rules were in full effect for the first time during the 2004 proxy season.

Affected Corporate Constituents

The SEC regulations apply to approximately 3,700 mutual funds and 6,200 investment advisers[19] who have the power to vote shares they hold on behalf of clients. Hence, they affect tens of millions of mutual fund shareholders and investment management clients who can now make more informed decisions about investments and managers.

But the effect of the new rules may be far broader: for they open corporate elections to stakeholders – persons who may or may not own shares in a company but who have a distinct, definable interest in how the company operates. Stakeholders will now be able to see how mutual funds vote and why.

Making proxy voting a public matter will transform the governance of corporations. For the first time it will be possible to learn how mutual funds and investment advisers plan to vote, so clients and others can try to affect their votes.

Effect on Pensions

Pension schemes are not subject to SEC jurisdiction. So why should their trustees attend to the SEC's new rules?

Simply put, the SEC's redefinition of fiduciary duties as to equities will become the general rule. Why? Trust lawyers, a notably conservative lot, will default to the most stringent statement of fiduciary duty.[20] Its simplicity will also appeal to them, as will its incorporation of important features of the *Restatement (Third) of Trusts* "prudent investor rule".[21]

As a practical matter, however, what will drive the rule's general adoption are the expectations of constituents. If the funds in their 401(k) or 403(b) or

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[19] The two sets of regulations are not identical. The SEC was not as prescriptive in the Adviser regulations. Advisers only have to make these disclosures upon a client's request, while the funds must publish them for their clients.

[20] As noted earlier, the U.S. DoL has held that such a duty exists under ERISA. What Labor has not done – and why the SEC regulations will define the duty – is say how trustees will fulfill it. See p. 5, n.14, *supra*.

[21] *Restatement (Third) of Trusts (Prudent Investor Rule)* Section 227 (Washington, D.C.: American Law Institute, 1992). The rule itself does not mention social investing. However, Comment c. (pp. 8–9) approves of the practice. See also 3 A. Scott, *The Law of Trusts* (W. Fratcher 4th edition 1988) Section 227.17 which endorses the application of social criteria in investment decision-making by trustees under particular conditions. Until his death, Scott was the Reporter for the *Restatement of Trusts*. But see the Comment to the Uniform Prudent Investor Act (UPIA) (1994) Section 5 For a more complete discussion of the legal authorities, see the Appendix to this paper which quotes and discusses the UPIA.

457 plans must disclose, why shouldn't their defined benefit plan? If those funds and their advisers are engaging corporations on social, environmental, or governance issues, shouldn't their defined benefit plan?

A Unitary Fiduciary Duty

The SEC has now categorized proxy voting as a fiduciary duty. Hence, a trustee must exercise the same degree of care as to proxies as s/he does in managing money.

That summary of the SEC's rationale for its proxy rules may misstate what the Commission intended. An adviser or a mutual fund, the SEC may be saying, is a fiduciary as to all aspects of ownership embodied in a share of stock. The prudent fiduciary will assume the existence of a single standard.

A New View of Shareholder Rights

> *Far more serious than these ad hoc special relationships [between institutional investors and conglomerates] is the general problem created by lodging the power and responsibility for the selection and legitimation of corporate management in the hands of people who have disclaimed any interest in the election decision. The standard line of the institutional manager is: 'We vote with the management. If we don't like the management, we sell the stock.' Since institutions now own about one-quarter of the shares of the companies listed on the New York Stock Exchange, this attitude creates a rather large vacuum in the corporate election process.*
>
> David L. Ratner (1970).[22]

The SEC's new rules on proxy voting ended the era when advisers and mutual funds and pensions could ignore proxies or just vote with management.[23] By defending their regulations in terms of fiduciary responsibilities, the Commission foreclosed the possibility of resuming that practice.[24]

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[22] Ratner, D.L. (1970), The government of business corporations: critical reflections on the rule of "one share, one vote." 56 *Cornell L. Rev.* 1, 26.

[23] But see Chuck Jaffe, "Voting with your money: Proxy disclosure rules present a dilemma", CBSMarketWatch.com, April 25, 2004. The Muhlenkamp Fund, in response to the regulations, had adopted an explicit voting policy of always voting with management. Since this policy was widely reported in the trade press, it presents a direct challenge to the Commission to define its policy in practice.

[24] The DoL's "Avon Letter", *supra*, describes the duty as fiduciary and, by example, states it applies to resolutions proposing a change in the state of incorporation or a "poison pill". While plan sponsors or trustees may delegate the responsibility to vote proxies to a manager, they must "monitor" the votes. But the "Avon Letter" does not require public reporting of the votes and does not mention the need for public proxy voting guidelines. To the same effect, see *also DOL Interpretive Bulletin 94-2*, 29 CFR Section 2509.94-2 http://www.dol.gov/dol/allcfr/Title_29/Part_2509/29CFR2509.94-2.htm

More importantly, the SEC extended share voters' and stakeholders' ability to exercise supervisory control over publicly traded corporations. And most important of all, the Commission has required advisers and mutual fund companies to look at publicly traded corporations in all their aspects, not just their financials.

To grasp the full implications of what the Commission has done, one has to read together the SEC's rationales for the two sets of regulations.[25]

Advisers Act Rules

"Under the Advisers Act, … an adviser is a fiduciary that owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting."[26]

The Commission might have limited the duty to those aspects of proxy voting that affected financial performance – something, arguably, the Department of Labor (DoL) has done.[27] But the SEC's formulation applies to anything that can appear on a proxy ballot, from the election of directors to social issues.

"Monitor Corporate Events"

As noted earlier, the adviser and mutual fund regulations are not identical.[28] The adviser rules are more vague on what an advisor must do than are the mutual fund rules: "The duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies."[29]

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[25] The rationales for administrative regulations state the agency's case for their adoption. They are best thought of as anticipatory briefs for a federal Court of Appeals reviewing the agency's authority to adopt the rules. They describe for the court what the agency intended and the legal basis on which its assertion of jurisdiction rests. The SEC's rationales for the two sets of proxy regulations are models of their kind.

[26] Adviser Regulations rationale, op. cit. See the Appendix, below, on how the duty of loyalty applies generally to socially responsible investing.

[27] The DoL's "Avon Letter" (1994) states, in part: "In general, the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock." ERISA issued the letter in the midst of the takeover mania from which the pension fund variety of shareholder activism emerged. (See discussion below.) Not surprisingly, Labor did not detail the nature of the fiduciary relationship, nor did it specify what or how trustees should consider and report. Nothing in the Avon letter would prevent a general policy of voting with management, for instance. http://www.lens-library.com/info/dolavon.html. See *also DOL Interpretive Bulletin 94-2*, 29 CFR Section 2509.94-2 http://www.dol.gov/dol/allcfr/Title_29/Part_2509/29CFR2509.94-2.htm

[28] The SEC adopted the respective regulations under different statutes, but that is not the reason for the differences in rationale and approach.

[29] Adviser Regulations rationale, op. cit. The "Avon Letter", *supra*, notes the duty of trustees to monitor the performance of managers to whom they have delegated voting authority.

"To monitor corporate events": What does that mean for an adviser? The Commission's rationale for its mutual fund regulations may answer that question:

The following are the examples of specific types of issues that are covered by some funds' proxy voting policies and procedures and with respect to which disclosure would be appropriate:

- corporate governance matters, including changes in the state of incorporation … and anti-takeover provisions such as staggered boards …;
- changes to capital structure …;
- stock option plans and other management compensation issues;
- social and corporate responsibility issues.[30]

The funds whose guidelines the Commission cited are all social funds.

In my view, the plain implication of this list is that advisers and mutual funds should now monitor the same types of events as KLD has reported on for 13 years.[31] The SEC's examples indicate that it has adopted – in this context, at least – social investors' view of what fundamental analysis should include and, I would argue, what fiduciary responsibilities now rest on trustees.[32]

The DoL Position

In its *Interpretive Bulletin 94-2*, the DoL outlined the duties of trustees under the Employee Retirement Income Security Act of 1974 (ERISA) as to investment policy statements and proxy voting.[33] The first sentence of part (3) of the

[30] Mutual Funds Regulations rationale, op. cit.

[31] *But compare* Rounds Jr., C. E. (2004). *Loring A Trustee's Handbook* (2004 edition). New York: Aspen Publishers, Section 3.5.3.1(e) (hereafter "Rounds, *Trustee's Handbook*") which asserts the trustee must "act solely in the economic interests of the beneficiary in light of the manifested intentions of the settlor." As discussed in the Appendix, below, Prof. Rounds is too broad in his claim. (Rounds does not address the SEC proxy regulations in this section or in Section 3.5.3.1(e) "The power to vote proxies", though they appeared in January 2003 and his book in 2004.) He is on more solid ground here when he adds, "One has no power as trustee to indulge one's own social and political predilections with the stockholder's franchise." It probably goes without saying that the operative word here is "indulge".

[32] It is possible, as one reviewer of this paper commented, to give "corporate events" a very limited definition, encompassing only things of the magnitude of a merger, a bankruptcy, *etc.*, and therefore excluding social proxy questions and the like. This usage is common among one narrow sector of the financial services industry, benchmark index providers. The SEC's repeated use of the word "issues" in its list of examples, I think, disposes of this argument. *DoL Interpretive Bulletin 94-2*, quoted above, uses "issues".

[33] *DOL Interpretive Bulletin 94-2*, *supra*, 29 CFR Section 2509.94-2(3) http://www.dol.gov/dol/allcfr/Title_29/Part_2509/29CFR2509.94-2.htm

Bulletin, adopted in 1994, states:

> An investment policy that contemplates activities intended to monitor or influence the management of corporations in which the plan owns stock is consistent with a fiduciary's obligations under ERISA where the responsible fiduciary concludes that there is a reasonable expectation that such monitoring or communication with management, by the plan alone or together with other shareholders, is likely to enhance the value of the plan's investment in the corporation, after taking into account the costs involved.

Bulletin 94-2 acknowledges that such "a reasonable expectation may exist in various circumstances. …"[34] It then lists a number of standard governance-type issues, followed by "assuring that the [corporation's] board has sufficient information to monitor management".[35] There follows a second list of governance-type issues which concludes with:

> the nature of long-term business plans, the corporation's investment in training to develop its work force, other workplace practices and financial and non-financial measures of corporate performance.[36]

Given a broad – but not unreasonable – reading, the DoL's *Interpretive Bulletin 94-2* is roughly congruent with the SEC's Mutual Fund regulations. The scope of what is commonly understood to be within a corporate board's purview has changed since 1994. More importantly, so has the conception of what enhances "the value of the plan's investment".[37]

"Corporate Governance": A New Substance

In the Mutual Fund regulations, the SEC swept away the decade-old distinction between social and governance issues. "Corporate governance" has lost its earlier definition and become a catch-all for subjects of administrative reforms ranging from auditor independence to directors' fees to executive compensation.

In the context of these issues and "corporate events", the SEC has restored "corporate governance" to its old meaning: the structures and procedures used to organize a corporation – directors' terms, board committees, senior executives' lines of authority, and the like.

The SEC's focus has shifted beyond "corporate governance" to how a company is being run: corporate *governing*. That is the significance of the list of

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[34] *Id.*
[35] *Id.*
[36] *Id.*
[37] *Id.*

examples of activities mutual funds must monitor. This interpretation may signal increasing power for shareholders and stakeholders, but a substantial barrier – of the SEC's creation – exists.

The SEC's rules on access to the proxy ballot limit the issues that shareholders may raise are limited. The "ordinary business" exemption keeps off the ballot matters relating to the company's day-to-day operations. It has also kept off issues such as an option plan for officers and until 1999 discrimination in hiring against gays.[38] Former SEC Chair Harvey L. Pitt suggested in a September 2003 speech that the exemption be dropped. But, no proposed rules have appeared.[39]

How much control the redefined fiduciary duty as to proxy voting may shift to shareholders is unclear. Nonetheless the only remaining question is: How much farther will this ownership revolution go?

"Owning" and "Governing": The SRI Template

> *It has often been said that the owner of a horse is responsible. If the horse lives he must feed it. If the horse dies he must bury it. No such responsibility attaches to a share of stock. The owner is practically powerless through his own efforts to affect the underlying property.*
>
> Adolf A. Berle & Gardiner C. Means (1932).[40]

For pensions, the SEC's new interpretation of an advisor or fund's fiduciary duties presents a knot of conceptual problems which today lack black-letter-law solutions.

On the one hand, pensions' primary duty is to fund their obligations to beneficiaries.[41] On the other, as major factors in our financial and corporate systems, pensions have an obligation to advance integrity and legitimacy[42] if for no other reason than their ability to meet their financial obligations depends on the health of those interrelated systems.

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[38] Securities & Exchange Com'n, "Amendments to Rules on Shareholder Proposals", Release Nos. 34-40018, IC-232000, May 21, 1998, 1998 SEC LEXIS 1001.

[39] "It is my hope that we can eliminate this exception, making shareholder suffrage a reality, and sparing our Staff from trying to resolve what is, or isn't, within the purview of ordinary business issues facing public companies." Harvey L. Pitt, "Remarks Before the Council of Institutional Investors' Fall Conference", September 23, 2002. http://www.sec.gov/news/speech/spch582.htm

[40] Adolf, A. B. & Gardiner, C. M. *The Modern Corporation and Private Property* [1932] New Brunswick, NJ: Transaction Publishers, 1990, p. 64 (hereafter "Berle & Means").

[41] By using "primary" here, I do not ignore the statutes which make this duty the sole one of pension schemes. It is the first, the main duty of all pensions regardless of governing legislation.

[42] Robert A. G. Monks & Nell Minow made this point a decade and a half ago in their important book, *Power and Accountability* (New York: HarperCollins, 1991). Now out of print, the book is available in full on line: http://www.thecorporatelibrary.com/power/index.html

Put differently, in my view the pensions' ability to perform their primary duty – to meet their obligations to their beneficiaries – depends on their positive roles as part of our financial system and as owners – but not managers – of corporations. While distinct in description, the three roles intertwine and are inseparable in practice.

In defining these roles, SRI offers a ready-made template. For SRI has focused for the 35 years on what it means to own a publicly-traded company and to govern it – the issues on which the legitimacy of the American corporate-financial system depends.

Taking Responsibility for Ownership

"SRI" – an ungainly phrase – has the virtue of turning on "responsibility". Properly understood, a "responsibility" is an obligation one imposes on one's self. Unlike a duty, neither cultural expectations nor the law imposes it.

Nothing requires shareholders to assume the responsibility to act as owners of a corporation in the way partners would own their business. In fact as Adam Smith pointed out in 1776, the opposite is true:

> [Shareholders] seldom pretend to understand anything of the business of the company; and when the spirit of faction happens not to prevail among them, give themselves no trouble about it, but receive contentedly such half yearly or yearly dividend, as the directors think proper to make to them. This total exemption from trouble and from risk, beyond a limited sum, encourages many people to become adventurers in joint stock companies, who would, upon no account, hazard their fortunes in any private copartnery.[43]

By its legal nature, the joint stock company (the modern "corporation")[44] freed its owners from liability for anything beyond their investment. The shareholder's freedom from accountability made these business organizations noxious to Smith. In partnerships (Smith's "copartnery"), the partners are liable for debts each incurred,[45] and the liability is not limited, as shareholders' is to the amount of their investment. In the 18th century, bad business judgment

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[43] Smith, A. (1981), *The Wealth of Nations* [5th edition 1789 (Glasgow ed.)]. Indianapolis, IN: Liberty Press, 1981, p. 741 [V.i.e.18].

[44] When Smith uses "corporation", he refers to organizations such as the medieval guilds, municipal corporations and universities which received grants of monopolies and/or the control of aspects of trade from the Crown. The historical relationship between "corporations" and "joint stock companies" is obscure and it is best to think of them as distinct types of entities. See *generally* Davis, J. P. *Corporations* [1905] Washington: Beard Books, 2000.

[45] In law, this is termed "joint and several liability", and it explains why, next to trustees, partners have the most stringently enforced fiduciary duties.

could result in confinement in a debtors prison – which made Rikers Island look like "Club Fed" – until the debtor died or the debt was satisfied.

Smith's theme has recurred in Anglo-American political life for 230 years. In 1967, the economist Gardiner C. Means could write:

> At the same time that economic power has built up in the hands of corporate management, the separation of ownership and control has released management from the overriding requirement that it serve stockholders. Profits are an essential part of the corporate system. But the use of corporate power solely to serve the stockholders is no longer likely to serve the public interest. Yet no criteria of good corporate performance have yet been worked out.[46]

Within 5 years of when Means wrote, a new concept of ownership and a new framework for judging corporate performance had emerged from the turmoil that was the late 1960s and early 1970s. This took the form of SRI.

Activism and Screening: SRI's Parents

> *Let us be clear: if the billions of dollars that companies spend on their direct operations are spent in a principled manner and fall within the skills and direct responsibilities of the company, this will have a far greater impact on world problems than any arbitrary philanthropy, even if this runs into millions.*
>
> Sir Geoffrey Chandler (2004).[47]

SRI as it now exists emerged in the United States in the late 1960s. It had two parents – shareholder activism and social screening – who quickly joined.

Shareholder activism, here defined as the use of the right to vote conferred by share ownership to raise social, environmental, or corporate governance issues with a corporation, began in the mid-1960s with actions at Kodak. By the time of Campaign GM and the founding of the Interfaith Center for Corporate Responsibility in the early 1970s, shareholder activism looked much as it does today.[48]

The other SRI parent is social screening, the inclusion of social, environmental, or ethical criteria in the investment decision-making process usually with the purpose of making the investments one owns as consistent as possible with one's ethics or mission. It has a much longer history than shareholder activism, perhaps dating to the 17th century.[49]

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[46] Gardiner C. M. (1967). *Implications of the Corporate Revolution in Economic Theory*, in Berle & Means, op. cit., p. xlvii.

[47] Sir Geoffrey Chandler (2004). CSR: the international aspects, Keynote Address, *Conference on CSR and the Role of the Lawyer*. Amsterdam, June 25, 2004.

[48] See *generally* Vogel, D. (1978). *Lobbying the Corporation*. New York: Basic Books.

[49] Kinder, P. D. et al. (1993). *Investing for Good* (pp. 12–15). New York: HarperCollins.

Historically, social screening has been – and continues to be – a statement about what are appropriate products and business practices. So, 18th century Quakers refused to participate in the weapons or slave trades, and evangelical Christians declined to own alcohol or tobacco stocks in the 20th century. In 1969, a group of Methodist ministers founded the Pax World Fund, the first mutual fund that held itself out as screening on issues beyond alcohol or tobacco.

SRI's Concept of Responsibility

So, by 1970 two distinct SRI approaches to share ownership had emerged: shareholder activism which focused on particular issues at specific companies and social screening which focused on issues affecting industries or lines of business.

Both shared a common basis: the owners' assertion of responsibility for the actions of the companies they owned. In short order, a broader range of people – stakeholders – came to realize that pools of assets, of which they were direct or indirect beneficiaries, invested in companies whose activities they regarded as unacceptable.

The issue that aroused that awareness was South Africa.[50] And, it was in that context U.S. pensions first encountered social investing.

Pensions and South Africa

In its relationships with institutions, South Africa transformed SRI.[51] That transformation led to an approach to ownership pensions should adopt today.

For more than a decade, the Sullivan Principles provided a focal point and a series of lenses for SRI on South Africa. The Principles amounted to an aspirational code for companies doing business in South Africa. A respected consulting firm, Arthur D. Little, devised a set of graduated rankings representing evaluations of corporate performance against the standards.

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[50] Here is not the place to look at the history of SRI and South Africa. Two points, however, should be noted. First, shareholder activists played a critical role in publicizing and organizing around the issue. As engagement evolved into divestiture, they also advanced the legislative agenda. But, SRI's role was in support of a larger movement made up of many organizations with different strategies toward the same end. Second, South Africa has received the same revisionist treatment that *Brown v. Board* has gotten: Change was inevitable and clearly on its way, so the trauma caused by those in a hurry was unnecessary. As one who lived for a time in rural Florida in 1966, I find the argument obscene in the case of Brown and contrary to all evidence in the case of South Africa. See *generally* Massie, R. K. (1997). *Loosing the Bonds.* New York: Nan A. Talese/Doubleday.

[51] South Africa, however, was not a catalyzing issue for most individual investors which is why SRI survived the end of sanctions and the scurry away from social screening by pensions and endowments.

The most important effect of the Sullivan Principles and the corporate rankings was that they forced shareholders and activists to recognize nuances and differences in corporate performance. One size did not fit all. That recognition led to changes in their approaches to corporations. Dialog – via shareholder activism – and incremental progress became SRI's lodestones.

Research and Divestment Decisions

The data developed for the Sullivan rankings, the South Africa reports the companies issued and the evaluations of proxy resolutions produced by the Investor Responsibility Research Center (IRRC) set standards for what information companies could generate on social issues and for how social investors should evaluate it.

Some issues – tobacco most notably – would remain categorical exclusions, but South Africa established the principle that an in-out approach would not apply to complicated issues such as the environment, labor relations, and the like. There, nuanced judgments had to be made.

Starting in 1988, KLD began systematizing SRI screens in the context of developing the Domini 400 Social Index.[52] Today, KLD reports on nearly 100 screens under the following headings:

Qualitative screening areas	Exclusionary screening areas
Community	Alcohol
Corporate governance	Firearms
Diversity	Gambling
Employee relations	Military Weapons
Environment	Nuclear Power
Human rights	Tobacco
Product quality and safety	

Taken together, these screens amount to the most comprehensive and widely accepted statement of the social and environmental characteristics against which investors and, indeed, the public evaluate U.S. corporations.

As a gauge of CSR and sustainability, this framework has many limitations – and the last sentence many qualifications. Not the least of these are that the screens must be of general applicability to American corporations and that data exists on which to base KLD's decisions.[53]

[52] KLD maintains five benchmark indexes of which the Domini is the oldest. They were originally intended to gauge the costs of social investing.

[53] A complete statement of KLD's screens will be found in "Sustainable & Socially Responsible Investing" (KLD Research & Analytics, Inc., 2004) and at http://www.kld.com/research/ratings.html

Screening and Pensions: A Final Note

In the end, South Africa proved that pressure of many different types on corporations, pensions, and endowments could affect the course of social change. U.S. institutions – pensions included – and the corporations they owned responded to shareholder activists and, at the end, state and federal legislatures.

But while the interaction with institutions may have transformed SRI, it did not transform the pensions.[54] At the same time that the pensions were being forced to divest, Modern Portfolio Theory (MPT) began its rise to dominance.

MPT's mantras on diversification and risk merged with hoary arguments against social screening.[55] On that basis, it has now become received doctrine that pensions "can't" screen on social, environmental, or governance issues – even amongst those that pursue active or sectoral investment strategies which by their nature require screening based on industry groupings, stock characteristics, or the like.

Yet, how a social investment mandate might be different from an active or style mandate rarely enters the screening opponent's invocation of financial probity. Outside of passive market-basket approaches, the argument against social and environmental screening – regardless of the benefits they might bring – is visceral, not reasoned.

A trustee told me at a conference in 1994, "I had South Africa shoved a mile up my ***, and it'll never happen again." For 10 years, he has been right. Corporate governance and a new way of looking at fiduciary duties on proxy voting may prove him wrong ultimately.

Activism and Engagement

> *To measure the effectiveness of an ethical sanction by whether it caused a country to make a U-turn makes as little sense as to describe sanctions against South*

[54] See *Bd. Of Trustees v. Mayor of Baltimore City*, 317 Md. 72, 562 A.2d 720 (1989), *cert. den. sub nom. Lubman v. Baltimore City*, 493 U.S. 1093, 107 L.Ed. 2d 1069, 110 S.Ct. 1167 (1990) which is discussed and quoted at length in the Appendix to this paper. In this, the only English-language case involving SRI to have a full trial and reach a court of last resort, the trustees failed to overturn an ordinance which would have required them, under limited circumstances to divest. Nonetheless by the end of sanctions in 1994, I am told, the trustees had never divested despite losing the case.

[55] By far the most important intellectual support for this argument comes from Langbein, J. H., & Posner, R. A. (1980).Social investing and the law of trusts, *79 Mich. L. Rev. 72* (hereafter "Langbein & Posner"). Uninhibited – as often in their writings – by the dearth of supporting data, Langbein & Posner asserted pension trustees violated their fiduciary duties by applying social screens. The best gauge of the article is their definition of social investing: "excluding the securities of certain otherwise attractive companies … because the companies are judged to be socially irresponsible, and including the securities of certain otherwise unattractive companies because they are judged to be behaving in a socially laudable way. By 'attractive' and 'unattractive' we refer to the conventional objective of investment, which is to make money … for the investment beneficiary." At 73.

Africa as futile because they have failed to destroy apartheid before now. The aim is to influence for the better. And opportunism as well as absolute values must play a part.

Financial Times editorial (1990).[56]

As noted earlier, shareholder activism – now often called "engagement" – emerged at the same time as modern portfolio screening. They share common values' frameworks. They have nurtured and cross-pollinated each other for more than 35 years.

It is no small irony that today "shareholder activists" have become identified with pensions, especially CalPERS, rather than nuns. It is a still larger irony that "corporate governance" rather than "social and environmental justice" is the descriptor of choice for the issues raised in the proxy arena.

2004 Successes

As noted earlier, the SEC has suggested a range of concerns broader than governance that should go into trustees' evaluations of the companies whose stock they hold.[57]

Signs have appeared amongst the news from this year's annual meetings that institutional shareholders responded to the SEC's nudging with an avalanche of actions.[58] And the companies have responded. The agreement of American Electric Power and Southern Company to report on climate change issues is the clearest of these.[59]

Shareholder actions almost always target large, highly visible companies. Their proponents hope that change at the top will cause other companies to follow. Hence, they target Procter & Gamble, the Gap, and the like. Usually the issues fall within the screening issues typically applied by social investors. In many instances – most notably with South Africa and the environment – shareholder actions have led to increased refinement in screens and screening.

Activism's Limitations

Shareholder activism has real limitations for effecting change. For one thing, it targets particular issues at particular companies. A diversity issue at ExxonMobil or Cracker Barrel may have little application to companies at large.

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[56] The ethical ways to invest. *Financial Times (London)*, April 14, 1990, 6.

[57] Mutual Fund Regulations rationale, *supra*.

[58] See e.g. MacDonald, G. J. (2004), A record year for shareholder activism. *Christian Science Monitor*, June 28.

[59] See Truini, J. (2004). A growing minority. *Waste News*, February 2; Stadelman, C. (2004). Utilities to release cost information for future environment rules. *Akron Beacon Journal*, Febuary 19; Power giants agree to report climate emissions to shareholders. *Environmental News Network*, March, 10, 2004. http://www.enn.com/news/2004-03-10/s_13807.asp

But if that is true of social and environmental resolutions, it is even more so of governance issues.

Governance activists almost never leave the Russell 1000 for their targets. And the threat of their efforts is little felt beyond that range. A limited focus, no matter how large the targets, means a limited effect. So, a limited focus does not reflect "ownership" of companies so much as "ownership" of shares, of fungible pieces of paper.

In contrast to the social and environmental activists, the great weakness afflicting governance activism is its lack of a comprehensive framework of standards. Its approach is fundamentally ad hoc in comparison with social screening[60] or the combination of screening and activism used by many socially screened mutual funds. Without a framework, it is difficult to justify the ultimate sanction: divestiture. If a dispute involves a principle and the company defeats moves to make it change, are shareholders simply to accept and go on?

It may be that social screens should become *standards.*

Pensions and Their Companies in the Future

> *An investment firm is set up to be responsible to a limited group of stakeholders – usually just the investors who are in it for a maximum return over time. Harvard is responsible to a much bigger group of stakeholders – its faculty, students, staff, and alumni.*
>
> Brian C.W. Palmer (2003).[61]

Are pensions, owners of companies, or speculators in shares? Do pensions have fiduciary duties to stakeholders beyond their beneficiaries? Much rides on the answers to those questions.

The New "Maximizing of Shareholder Value"

> *Unlike the conglomerate-builders, who buy shares largely to amass enough of the votes that are attached to them to take control of the company's assets, the*

[60] ISIS Asset Management (UK) (now F&C Asset Management, PLC) has developed what it calls a Responsible Engagement Overlay for its clients. This impressive effort may yield a comprehensive framework for activism. See e.g. "Quarterly REO Report (London: ISIS Asset Management, 1st quarter 2004).

[61] Graff, G. M. (2003) Social investing. *Harvard Magazine*, July, 76. Palmer is a Harvard lecturer on the study of religion and serves on the University's SRI committee. Prof. Palmer omitted from his list of stakeholders the public to which Harvard owes its tax exempt status as an educational institution and its unique status under Massachusetts law. See Mass. Const. chap. V, especially the first two clauses of Section II.

institutional investors generally want shares only for the possibility of profit or return. They do not really want the votes, which require them to make decisions for which they do not want to be held responsible.

David L. Ratner (1970).[62]

Shareholder activism as presently practiced by pensions reveals its bastard heritage. It is the product of the paroxysm of acquisitions and leveraged buy-outs in the 1980s.[63] Raiders and pensions alike justified their actions by invoking "the maximization of shareholder value".[64]

This co-operation had fatal consequences for the legitimacy of the American corporate system. Writing at the time, Monks & Minow rightly argued:

> The ultimate death of the corporate myth, the theory under which management owed shareholders a greater duty than they owed themselves, came with the widespread acquiescence to the so-called management buyout. ...[65]

It may be that the pensions' abetting of corporate restructuring served their beneficiaries in the short run. But it will be sometime before a verdict is rendered on the 1980s consolidation from a social and economic perspective.

Speculators and Owners

"Maximization of shareholder value" in this context was consistent with the interests of a speculator but not of an "owner". There was little or no concern for the well-being of the juridical person, for the enterprise that by law has a life independent of its shareholders. There was certainly no regard for the interests of other stakeholders in the enterprise.

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[62] Ratner, D. L., op. cit., p. 26.

[63] See "The Avon Letter", *supra*. It bears noting that the only two practical examples of issues the ERISA administrator cited were anti-takeover maneuvers. Also *DoL Interpretive Bulletin 94-2*, *supra*, and the Uniform Prudent Investor Act, discussed in the Appendix, infra, were adopted within days of each other in the Summer of 1994 and within a few weeks of the end of sanctions on South Africa. Neither 94-2 nor the UPIA even implicitly refers to the controversy over how South Africa affected both proxy voting and the trustee's duty of loyalty. Given the heat of this controversy for the preceding 15 years, this is at least odd.

[64] The focus of shareholder activists on abolishing the "staggered board" is a continuing example of this heritage. Its only rationale is making it easier to flip control. It is directly contrary to every notion of what actually constitutes good governance in administrative agencies – entities often with far less impact on society. Continuity in oversight and management are positives, not negatives, except where control is at issue. It also mitigates toward long-term thinking, rather than quarter-by-quarter management.

[65] Monks & Minow, op. cit., pp. 47–48.

The SEC's proxy voting regulations take a different – albeit not distinct – view. They explicitly contemplate a concept of ownership that takes in considerations traditionally regarded as "non-financial" – social and corporate responsibility issues.[66]

What then will the prudent investors who manage and supervise pensions do?

SRI's Lenses for Corporate Evaluation

Socially responsible investors offer pensions a model of ownership. They are long-term investors by choice rather than by size and necessity. They tend to be conservative investors and to be people concerned about the legitimacy and viability of our economic and political systems.

The circumstances in which today's prudent investors find themselves dictate a close attention to corporate governing, how a company is run across their full dimensions. Imperfect as it is, the framework developed by social investors over the last 30 years provides a systematic means for dealing with the large numbers of companies whose stock the typical pension holds.

In 1991, the redoubtable Robert Monks and Nell Minow wrote:

> All of the ingredients now exist for the re-establishment of a traditional system of trust on which an ongoing and productive system of corporate governance can be built. The essential elements are a stable base of permanent shareholders represented by trustees who exercise care and loyalty.[67]

Sadly, they were wrong then. There is little reason to think that they are right today. But the stakes are much higher for pensions now, and they must act like owners if they are to carry out their mission "not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."[68]

By returning to the classical concept of prudence, pensions can redefine the maximization of shareholder value.

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[66] Again, as noted at the outset, pensions are not subject to the SEC's 2003 proxy voting regulations. Lest my conclusions seem radical, a recent survey by an Anglo-German mega-firm discusses this paper and comments, "It is not yet certain to what extent this argument presently reflects US securities law as applied. It is clear, however, that the argument is in keeping with the general direction of US fiduciary law as this has developed since the1990s."

Freshfields Bruckhaus Deringer, "The Legal limits on the Integration of Environmental, Social and Governance Issues into Institutional Investment," (New York & Nairobi: UNEP Finance Initiative, September 16, 2005), p. 119. http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf

[67] Monks & Minow, op. cit., p. 244.

[68] *Harvard College v. Amory*, 9 Pick. (26 Mass.) 446, 461 (1831).

Appendix

Notes on Loring A Trustee's Handbook (2004 ed.) Section 6.1.3

> *For me, the twisting of the law by lawyers is especially troubling. I have spent my life believing that the safety of this difficult, diverse country lies to a significant extent in the good faith of lawyers – in their commitment to respect the rules.*
>
> Anthony Lewis (2004).[69]

In law school legal research courses, one learns to disdain legal encyclopedias and treatises as the least valuable of legal authorities. In law practice, one finds they are indispensable for their pedantic reliability. And the young lawyer comes to rely on them as his starting point. Or rather on some of them, for others – which he describes with expletives – have misled him.

Because my first job as a lawyer was in the Charitable Trusts Section of the Ohio Attorney General's Office, I am especially aware of the value of treatises and acutely sensitive to their quality. While there, I worked on a major case which traipsed across uncharted territory. And we were lost.

One of my peers discovered a Rosetta Stone: Marion Fremont-Smith, *Foundations and Government: State and Federal Law Supervision* (Russell Sage Foundation, 1965). Thirty years later, I can still feel the relief and, later, assurance her invaluable treatise provided. So, I bring a certain perspective to my examinations of treatises.

These thoughts arose while I prepared for a conference at the American Enterprise Institute in June 2004 at which I presented an earlier version of the main part of this paper. I had looked at the treatise authored by my co-panelist, Prof. Charles E. Rounds Jr.,[70] which he had cited 13 times in his paper.[71] This Appendix describes what I found there about SRI and what I believe to be its deficiencies.

SRI: "Indirect Benefit" to Trustee?

I focused, in particular, on a discussion in Section 6.1.3.4 "Indirect Benefit Accruing to the Trustee", which he did not discuss in his paper[72] but certainly echoed.

[69] Lewis, A. (2004). Making torture legal. New York Review of Books, July 15, pp. 4, 6.

[70] Rounds, *Trustee's Handbook*, op. cit.

[71] Rounds Jr., C. E. Public pension funds, charitable fund, and the social security trust fund: when the state gets into the investment business, social investing is inevitable and here is little the law can do about it, *paper presented at the American Enterprise Institute*, June 7, 2004. http://www.aei.org/events/eventID.832,filter.all/event_detail.asp

[72] *But* see *id*., p. 13 where he discusses a footnote to this section but not in the context of the fiduciary issues addressed in this Appendix. Rounds does not define or give an example of an "indirect benefit".

He begins with a classic example of a trustee usurping a trust asset for his/her benefit. He notes the temptations trust assets can pose for trustees and urges conduct like that of "Caesar's wife".[73] Then, Rounds identifies social investing as one of those temptations:

> Social investing has been defined by Professor Langbein and Judge Posner as the "pursuit of an investment strategy that tempers the conventional objective of maximizing the investor's financial interests by seeking to promote non-financial social goals as well." A trustee who without express authority in the governing instrument voluntarily undertakes to practice social investing uses the trust estate, i.e., other people's property, to promote the trustee's own political and social goals – a clear case of indirect self-dealing.[74]

Leaving aside the question of how one can clearly deal indirectly with oneself, the loaded language yields a valid point: a trustee cannot use trust assets to "promote" his or her "goals".[75] But, that does not mean even trustees lacking express authority are categorically barred from applying social or ethical criteria, as I will show later.

SRI: "Acting on Divided Loyalties"?

Rounds goes on to argue that yielding to third-party demands to apply social criteria amounts to "acting on divided loyalties" and that trustees, by so doing, "may be subordinating the interests of the trust to the interests of the trustee."[76] Then comes:

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[73] Given the conduct of the wives of the Caesars – Augustus, Caligula and Claudius, especially – this seems an inappropriate caution. An entertaining if utterly wrong-headed law journal article argues for a lesser test, in fact a cost-benefit analysis that might allow Caesar's wife to justify violations of the duty of loyalty on the basis of benefitting the trust. See Langbein, J. H. (2005). *Questioning the Trust Law Duty of Loyalty*, 114 Yale L. J. 929. It is a splendid example of the "law and economics" model offering a remedy for something that has worked very well for 200 years.

[74] Rounds, *Trustee's Handbook* Section 6.1.3 at pp. 277–278 (footnotes omitted). The Langbein-Posner SRI definition is discussed at note 36 above. In support of the propositions in his final sentence, Prof. Rounds cites a libertarian journal which criticizes Ralph Nader's stock holdings and Rounds's memorable law journal article on interest on lawyers' trust accounts (IOLTA). *Id.*, p. 278, nn.164, 165.

[75] Unless, of course, they happen to correspond with the trust's – a far from uncommon situation.

[76] *Id.*, p. 278. For these propositions, Rounds cites, respectively, a *Wall Street Journal* article on the controversy over the Hershey Trust and Langbein & Posner, op. cit., at pp. 278–279, nn.166–168. The last footnote contains an extended discussion of the DoL's interpretations of ERISA as it applies to Economically Targeted Investments (ETIs). *Compare* Robert A.G. Monks & Minow, N. *Power and Accountability*, op. cit., p. 221, who argue, "The traditional trust concept of an undivided duty of loyalty may not be possible in the context of pension funds, where both fiduciaries and beneficiaries are so divided in needs, priorities and responsibilities." Monks served as ERISA administrator during the first Reagan administration.

> If social investing has any place in the law of trusts, it is incumbent upon the courts and the legislatures to create objective standards, *i.e.*, to define away this exception to the trustee's duty of undivided loyalty in a way that establishes reasonable limits on a trustee's right to promote with the trust estate his own personal, political, and social goals, or the personal, political, and social goals of third parties.[77]

In fact, the parameters of a "trustee's right to promote with the trust estate … personal, political, and social goals" are well-established. But Prof. Rounds chose to ignore what didn't fit his viewpoint – a cardinal sin for a treatise writer.

Scott's General Rule

The late Harvard Professor, A.W. Scott, stated the basic rule on trustees and SRI:

> Trustees in deciding whether to invest … may properly consider the social performance of the corporation. They may decline to invest in, or to retain, the securities of corporations whose activities … are contrary to … ethical principles. They may consider such matters as pollution, race discrimination, fair employment, and consumer responsibility.[78]

Prof. Scott did not assume, as Prof. Rounds does, that applying such criteria must necessarily reveal the trustees' improperly divided loyalties. Rather, Scott asserts the trustees' investment decisions may reflect the principles, the values of their community.

The Restatement (Third) of Trusts

Prof. Scott was the long-time reporter for the *Restatement of Trusts*, the most influential treatise in the field. A project of the American Law Institute, the *Restatements* attempt to compile and codify the common law of America's 50 states and, as in the case of social investing, to fill in the blanks.

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[77] *Id.*, p. 279. "Incumbent on the courts and legislatures": One U.S. court of last resort has spoken on precisely these issues, but Rounds does not cite – much less discuss – its opinion which runs counter to his. Prof. Rounds cites neither Scott, nor the *Restatement (Third)* prudent investor rule, nor the ERISA administrator's Advisory Opinion 98-04a, much less *Bd. of Trustees v. Mayor of Baltimore City* – all of which are cited and discussed below. The most recent of these has a publication date 6 years before Rounds's treatise's

[78] 3A. Scott, *The Law of Trusts* (W. Fratcher, 4th edition, 1988) Section 227.17. See the discussion below of *Bd. Of Trustees v. Mayor of Baltimore City*, 317 Md. 72, 562 A.2d 720 (1989), *cert. den. sub nom. Lubman v. Baltimore City*, 493 U.S. 1093, 107 L.Ed. 2d 1069, 110 S.Ct. 1167 (1990) which quotes this language approvingly. *But compare* Langbein & Posner, *supra*, at pp. 99–100, who correctly note Scott's lack of supporting citations for this proposition and ERISA's contrary implications. Given Langbein & Posner's lack of supporting data and citations for their positions, their argument against Scott seems a classic pot-kettle proposition.

In 1992, the *Restatement*'s "prudent investor rule" appeared. The rule itself does not address SRI but the comments to the rule – which courts and lawyers rely upon – do.[79] Here the general rule is closer to Rounds's approach, but it is not inconsistent with Scott's:

> [In] managing the investments of a trust, the trustee's decisions ordinarily must not be motivated by a purpose of advancing or expressing the trustee's personal views concerning social or political issues or causes. Such considerations may properly influence the investment decisions of the trustee to the extent permitted by the terms of the trust or by the consent of the beneficiaries.[80]

In the area of charitable trusts, the *Restatement* suggests trustees have considerable latitude in applying social criteria:

> [S]ocial considerations may be taken into account in investing the funds of charitable trusts to the extent the charitable purposes would justify an expenditure of trust funds for the social issue … or to the extent the investment decision can be justified on grounds of advancing, financially or operationally, a charitable activity conducted by the trust.[81]

So, it would seem that trustees of a charitable trust can lose on social investments an amount roughly equivalent to what they might grant to the same cause.

That is not a radical proposition. The *Restatement* recognizes the institutional imperative of, say, a Quaker institution to maintain a portfolio free of armaments manufacturers or a Catholic diocese to avoid primary-care facilities that perform abortions – even at some cost to their portfolios.

No one could argue public pension fund trustees might have the same discretion to lose money on a socially responsible investment program. Nonetheless, the *Restatement* does not reflect Prof. Rounds's concerns about SRI leading to divided loyalties or indirect benefits.

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[79] *Restatement (Third) of Trusts (Prudent Investor Rule)* Section 227 (Washington, D.C.: American Law Institute, 1992). The rule itself does not mention social investing. However, Comment c. (pp. 8–9) approves of the practice. *But compare* Uniform Prudent Investor Act Section 5, the comment to which says that under certain circumstances trustees can violate their duty of loyalty by implementing a social investment policy. See the discussion of this, below.

[80] *Id.* To the same effect, see *Uniform Trust Code* Section 802 Comment ¶2: "In the case of a charitable trust, the trustee must administer the trust solely in the interests of effectuating the trust's charitable purposes."

[81] *Id.* The Charity Commission for England and Wales has gone as far, too. Its guidelines make sophisticated distinctions between the types of social investments trustees may properly make. See "Useful Guidelines – Charities and Social Investment" http://www.charity-commission.gov.uk/supportingcharities/casi.asp

DoL PWBA Advisory Opinion 98-04A

In 1998, the Calvert Group sought an advisory opinion from the U.S. DoL on whether a defined-contribution plan subject to the Employee Retirement Income Security Act (ERISA) could include one or more socially screened mutual funds. It responded:

> The department has expressed the view that the fiduciary standards of sections 403 and 404 do not preclude consideration of collateral benefits, such as those offered by a 'socially-responsible' fund, in a fiduciary's evaluation of a particular investment opportunity. However, the existence of such collateral benefits may be decisive only if the fiduciary determines that the investment offering the collateral benefits is expected to provide an investment return commensurate to alternative investments having similar risks.[82]

The "commensurate return"/"similar risk" approach has been the department's since the early 1980s.[83] Again, no hint of concerns about the trustees' divided loyalties or indirect benefits.

Bd. of Trustees v. Mayor of Baltimore City

The only case on the fiduciary duties of trustees as to social investing to reach a court of last resort in an English-speaking jurisdiction is *Bd. of Trustees v. Mayor of Baltimore City* decided by the Maryland Court of Appeals in 1989.[84]

In this case, the trustees of the Baltimore City pension funds sought to void ordinances passed by the City Council which would have required them, under very limited circumstances, to divest their funds of stocks issued by companies doing business in South Africa. In the course of rejecting constitutional arguments not relevant here, the court addressed the trustees' duties of prudence and loyalty.[85]

The court's opinion is quite clear and at least as good as any summary of mine might be. So, I will quote from it at length.

> In a related argument, the Trustees contend that the ordinances alter the duty of prudence by mandating the consideration of social factors unrelated to investment performance. Under the circumstances of this case, we disagree.

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[82] "Calvert Letter", U.S. DoL PWBA Advisory Opinion 98-04A (May 28, 1998) http://www.dol.gov/ebsa/programs/ori/advisory98/98-04a.htm (footnote omitted).

[83] *Id.*, p. 3n2.

[84] *Bd. of Trustees v. Mayor of Baltimore City*, 317 Md. 72, 562 A.2d 720 (1989), *cert. den. sub nom. Lubman v. Baltimore City*, 493 U.S. 1093, 107 L.Ed. 2d 1069, 110 S.Ct. 1167 (1990).

[85] It might be argued that the court's treatment of the trustees' duties of prudence and loyalty is *dicta*. Given the court's elaborate response to the issues and its context, that seems unlikely. See *id.*, 562 A.2d at 736–738.

No less an authority than Professor Austin Wakeman Scott rejected the proposition that "trustees are rigidly bound to attempt to secure the maximum return, whether as to income or principal, consistent with safety."[86]

The court then quoted Scott's general rule on SRI which I quoted on p. 27.[87]

For this position, Scott relied in part on an analogy to the corporate fiduciary's limited right to make charitable contributions; just as the directors may conclude that charitable contributions are in the corporation's long-term interests, so too a trustee "may well believe that a corporation that has a proper sense of social obligation is more likely to be successful in the long run than those that are bent on obtaining the maximum amount of profits." "But," he continued, "even if this were not so, the investor, though a trustee of funds for others, is entitled to consider the welfare of the community, and refrain from allowing the use of funds in a manner detrimental to society."[88]

These views are consistent with the position that a trustee's duty is not necessarily to maximize the return on investments but rather to secure a "just" or "reasonable" return while avoiding undue risk. [Citations omitted.][89] As one commentator stated, a "trustee is under no duty to open a brothel in Nevada, where prostitution is legal, in order to maximize return to beneficiaries." [Citation omitted.] Thus, if, as in this case, social investment yields economically competitive returns at a comparable level of risk, the investment should not be deemed imprudent.[90]

The court then turned to the trustees' argument that the ordinances affected their ability to fulfill their duty of loyalty to the beneficiaries.

Moreover, as with the duty of prudence, the Baltimore City Code incorporates ERISA's formulation of the trustee's duty of loyalty (Article 22, Sections 7(h), 35(h)):

"The Board of Trustees shall discharge its duties … solely in the interest of the members and beneficiaries and:

1. For the exclusive purpose of:
(i) providing benefits to members and beneficiaries. …"

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[86] *Id.*, 562 A.2d at 736.

[87] 3A *Scott on Trusts*, op. cit., Section 227.17.

[88] *Bd. of Trustees*, *supra*, 562 A.2d at 736–737 (citations and footnotes omitted). I have heard it argued that corporate charitable contributions amounted to what Prof. Rounds terms an "indirect benefit", since executives and directors receive kudos – some distinctly tangible – for what the company has conferred. This argument seems much less far fetched than Rounds's about trustees and SRI.

[89] The court cited eight law journal articles and treatises in support of its statement. It then explicitly acknowledged Langbein & Posner, op. cit. as taking a contrary view. With that treatment *compare* Rounds, *Trustee's Handbook* Section 6.1.3 at pp. 277–280, nn.163–170.

[90] *Bd. of Trustees, supra*, 562 A.2d at 737. The court quoted J.C. Dobris, "Arguments in Favor of Fiduciary Divestment of 'South African' Securities", 65 Neb. L. Rev. 209, 232 (1986).

The Trustees urge that, by requiring them to consider the interests of persons other than the beneficiaries and by requiring them to manage the systems for purposes other than providing benefits, the ordinances change this duty.

It is clear that the trustee's duty of loyalty extends beyond a prohibition against self-dealing and conflict of interest, two wrongs that are not present in this case. Even if the trustee has no personal stake in a transaction, the duty of loyalty bars him from acting in the interest of third parties at the expense of the beneficiaries [Citations omitted.]

Nevertheless, we do not believe that a trustee necessarily violates the duty of loyalty by considering the social consequences of investment decisions. If, as in this case, the costs of considering such consequences are *de minimis*, the trustee ordinarily will not have transgressed that duty.

Although Professor Scott termed the trustee's duty of loyalty "[t]he most fundamental duty owed by the trustee to the beneficiaries," IIA *Scott on Trusts, supra,* Section 170, he clearly believed that the obligation could be reconciled with considering the ethical implications of the trust's investments. See III *Scott on Trusts, supra,* Section 227.17. Our conclusion is consistent with that belief. Moreover, our opinion in this case is broadly consistent with the requirement, embodied in the Baltimore City Code, that the trustees act "solely in the interest of the beneficiaries," and "for the exclusive purpose … of providing benefits." As Professor Scott recognized, under some circumstances trustees may well believe that, by investing in businesses with "a proper sense of social obligation," they will in the long run best serve the beneficiaries' interests and most effectively secure the provision of future benefits (Ibid.).

Consequently, the ordinances do not change the Trustees' duties of prudence and loyalty, which are implicit in the pension contracts.[91]

The Uniform Prudent Investor Act Section 5 Comment

Lest the sins of omission already noted seem unprecedented, a glance is in order at something which supports Rounds but is buried in a footnote to Section 6.1.3.[92]

The Uniform Prudent Investor Act is an extremely important statute which has been adopted in about 45 U.S. jurisdictions since its promulgation by the American Bar Association in 1994.[93] Section 5 states the duty of loyalty in one

[91] *Bd. of Trustees, supra*, 562 A.2d at 738. It might be argued that the Uniform Prudent Investor Act Section 5 would alter the court's holding on the duty of loyalty. As discussed above, the comment to that section takes a categorical approach to any social investments that would sacrifice the interests of the beneficiaries. Here, the plaintiffs could not show a loss to the pensioners through a diminution of their promised benefits. They could only show what *might* have been a nominal cost to the pension funds.

[92] Rounds, op. cit., p. 278, n.168.

[93] See Uniform Law Commissioners, Fact Sheet – Uniform Prudent Investor Act. http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-upria.asp. The Act was drafted by a committee of the National Conference of Commissioners of Uniform State Laws. The notes that follow discuss that committee and its membership.

terse sentence: "A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries."[94]

As is common in treatises and Uniform State Laws, the drafters accompanied the "black letter law" with a "comment" explaining the text and citing authority for it. As here, the gloss is usually many times longer than the statement it discusses.[95] And for courts and lawyers, the drafters' interpretation is as important as the text itself. The last paragraph of the comment to Section 5 begins,

> No form of so-called "social investing" is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries – for example, by accepting below-market returns – in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause.

In support of this proposition the comment then cites the Langbein and Posner article, discussed above, which in 1994 was 14 years old. As with Rounds, not one of the authorities discussed above in this appendix is cited in the comment, including the Maryland Court of Appeals decision. Not one – and the Maryland case was then five years old!

There follows, "Commentators supporting social investing tend to concede the overriding force of the duty of loyalty. They argue instead that particular schemes of social investing may not result in below-market returns."[96] The comment cites a couple of law journal articles in support of what the Reporter wishes the reader to believe are reluctant acceptances of the duty of loyalty – something the articles themselves don't question, just as the Maryland Court of Appeals doesn't.

The comment to Section 5 ends with this discussion:

> In 1994 the DoL issued an Interpretive Bulletin reviewing its prior analysis of social investing questions and reiterating that pension trust fiduciaries may

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[94] The Uniform Prudent Investor Act Section 5 and the Comment to it are to be found at: http://www.law.upenn.edu/bll/ulc/fnact99/1990s/upia94.htm. One reaches that site via the NCCUSL site, http://www.nccusl.org

[95] The Comment to Section 5 consists of four paragraphs. The last paragraph – which is 14 times longer than Section 5, itself, and contains as many words as the first three paragraphs combined – is the one under discussion here.

[96] Assuming, as I do, that John Langbein had something to do with the drafting of this comment (see p. 34, below), it is worth contrasting the treatment of data on SRI performance here and in his article with Richard Posner, discussed above. When the 1980 article appeared, there was virtually no performance data available. Then, Langbein & Posner simply made assumptions about how SRI portfolios must perform, and based their criticism on those assumptions. In 1994, mutual fund performance data existed for at least 20 funds and KLD's Domini 400 Social Index had reported data for 4 years. These data were ignored, presumably because they did not fit the Comment's implication that screened portfolios underperform.

> invest only in conformity with the prudence and loyalty standards of ERISA Sections 403-404. Interpretive Bulletin 94-1, 59 Fed. Regis. 32606 (Jun. 22, 1994), to be codified as 29 CFR Section 2509.94-1. The Bulletin reminds fiduciary investors that they are prohibited from "subordinat[ing] the interests of participants and beneficiaries in their retirement income to unrelated objectives."

It is sufficient to note that the phrase "social investing" does not appear in the cited DOL bulletin and that it does not review DOL's "prior analysis" of anything.[97]

How did this misrepresentation of the outstanding authorities come to be in the comment? I have found no "smoking gun". But, here are two intriguing facts.

- The American Bar Association adopted the UPIA in the summer of 1994, the same summer in which South Africa sanctions ended.
- John Langbein, whose longstanding opposition to social investing I've noted, was the Reporter for the UPIA[98] which it may safely be assumed gave him a strong voice in the drafting of the comment.

Whatever the explanation, the misrepresentation to bench and bar of the authorities cannot be justified.

The Treatise Author's Obligation

The point of this lengthy appendix is not that Prof. Rounds's *Trustee's Handbook* is wrong in its position that trustees violate their duty of loyalty when they apply social investment criteria. One state supreme court – the U.S. DoL, the SEC (probably), and a couple of treatises – disagrees with him.[99] The point cannot be said to be settled absolutely against him.

I have described the contrary opinions because, I believe, Prof. Rounds violated his duty to acknowledge authorities who disagreed with him. The writer of legal treatises bears a special obligation to his readers to guide them to all authorities on point.

Is Prof. Rounds right on what the law should be? In the end, that matters far less than the fact that he is wrong on the processes by which law should be researched and debated.

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[97] Interpretive bulletin relating to the fiduciary standard under ERISA in considering economically targeted investments, 29 CFR Section 2509.94-1. http://www.dol.gov/dol/allcfr/Title_29/Part_2509/29CFR2509.94-1.htm

[98] He is so designated in the list of UPIA committee members. http://www.law.upenn.edu/bll/ulc/fnact99/1990s/upia94.htm

[99] I have omitted a summary of the many law journal articles on the subject of SRI and fiduciary duties, since they rely mainly on the sources discussed above. A fairly complete collection of citations – both pro and con – will be found on KLD's web site: http://www.kld.com/resources/intro.html

Acknowledgments

While the responsibility for the accuracy of and the interpretations in this chapter is mine alone, I do want to acknowledge the efforts of several people who contributed to my work.

First, I would like to thank Jon Entine for conceiving of and organizing the Conference on Socially Responsible Investment & Pension Funds at the American Enterprise Institute in June 2004 to which an earlier version of this chapter was presented. It was a fine event, worthy of the great effort it required. I am especially grateful to him for rejecting my initial concept for this chapter and pointing – pushing – me in the right direction.

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Peter D. Kinder
March 11, 2005

10

Pension Funds and Socially Responsible Investing: More Risky Than Responsible Business

Sarah Fuhrmann

Introduction

The year 2005 opened with a heated debate on corporate social responsibility (CSR) and socially responsible investing (SRI) touched off by The Economist magazine, which dedicated an entire special section to CSR and called into question the role that CSR plays in business today. "By and large CSR is at best a gloss on capitalism, not the deep systemic reform that its champions deem desirable," the magazine wrote in its special survey of CSR, The Good Company.[1] Added Clive Crook, an Economist editor and the author of the report:

> Capitalism does not need the fundamental reform that many CSR advocates wish for. If CSR really were altering the bones behind the face of capitalism – sawing its jaws, removing its teeth, and reducing its bite – that would be bad: not just for the owners of capital, who collect the company's profits, but … also for society at large. Better that CSR be undertaken as a cosmetic exercise than as serious surgery to fix what doesn't need fixing.[2]

The report drew rapid defenses of CSR from proponents around the world who argued that the report focused too much on the "business case" and not enough on the more intangible benefits and implications of corporate responsibility (CR) programs. The Economist "wrongly defines CSR as corporate giving by hapless managers eager to ease their own social conscience and placate 'anti-capitalist' crusaders," wrote Business for Social Responsibility, a trade group for corporations involved in CSR in a response to the piece. "It fails to acknowledge even the possibility that companies derive value from CSR

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[1] Available at http://www.economist.com/displaystory.cfm?story_id=3555212

[2] Ibid.

efforts. These flaws, which seem to reflect the monolithic economic analysis popularized a generation ago by Milton Friedman fails to present a serious or useful critique of CSR."[3]

The scrutiny increased the volume in an ongoing debate on the value of CSR and its sister industry, SRI. Further rounds in the discourse included research by prize-winning economist Arthur Laffer, Ph.D., that found no direct connection between CSR activities and profitability.[4] Laffer's findings stood in stark contrast to those of CSR proponent Business Ethics magazine, which in a cover story announced "absolute, definitive proof that responsible companies perform better financially."

As the latest volley over the profitability and advisability of CSR and SRI continued, evidence mounted that pension funds were moving further into the field and leveraging their mammoth investing power to advocate for changes in corporate governance, among other issues.

"One of the more important *revolutionary realities* for financial executives is increased pension fund and institutional investor activism – a major factor for some companies and, many believe, now a permanent fixture in the life of capital markets," wrote corporate governance advisor Hank Boerner. "Pension fund trustees and managers, along with their outside advisors and money managers, have arguably become the most powerful investment force in the nation. Their combined influence on individual companies and in the capital markets is considerable, as corporate finance executives well know."[5]

The advisability of that growing involvement, however, is questionable, particularly in the case of public pension funds that invest on behalf of millions of retirees who, unlike private investors, do not have a direct influence on the selection of the stocks included in the funds' holdings. In addition, pension funds have themselves been the target of efforts by outside groups to influence their policies and positions, making an already volatile, politicized environment even more risky.

Understanding the CSR/SRI Context

> "The more accountable you are, the more vulnerable you are to being attacked."
> Richard Sandbrook, British Green Party member, *The Economist*, 2003

CSR and SRI and their related campaigns do not exist in a vacuum. To fully understand the context – and the potential risk to corporations, pension funds,

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[3] Available at http://www.bsr.org/Meta/caseforcsr_c.pdf

[4] A link to Laffer's report can be found at http://www.csrwatch.com/csr_profitability.htm

[5] Boerner, H. (2004). Pension fund "Socialism" and the American Economy. *Corporate Finance Review*, November/December.

and others that have become involved in this environment – it is important to examine the full context of modern advocacy and corporate campaigns.

Even considering the current and ongoing scrutiny of CSR and SRI, the environment remains problematic and corporations and others that undertake social programs or investments without a full understanding of the CSR/SRI industry players, their networks, funding and tactics can face significant risk of harm to their reputations and even their freedom to operate. In such an environment, the philosophy of "doing well by doing good" that often guides corporations' social-responsibility strategy is not a guarantee of success.

Much of the debate is couched in the negative: CSR groups often portray companies as being "bad;" social investing groups screen out companies that do not meet a variable range of criteria.

Using tactics that include shareholder resolutions, e-mail campaigns, product boycotts, annual-meeting protests, advertising, news releases, and more, CSR/SRI and related groups often seek to increase their influence on corporations directly and on the general discussion defining social responsibility in the mainstream media and elsewhere. The Internet, which makes it possible for these groups to put their strategic information in the hands of millions quickly and easily – and then take action on it – is a critical part of these campaigns.

By their sheer volume, advocacy-oriented non-governmental organizations (NGOs) and their powerful networks, crucial to setting environmental, socioeconomic, and other political positions, pose a risk to corporations, employees, and their shareowners. As noted by Jeffrey Hollender, CEO of the natural-products corporation Seventh Generation, "The number of NGOs and activist groups has now risen to an estimated 28,000 worldwide. With that many NGOs out there keeping a hawk's eye on possible corporate misbehavior, the risk of one of them targeting any particular company is now higher than ever before."[6]

In fact, Hollender's numbers are likely low; other reports put the figure much higher, in the hundreds of thousands when community-based organizations serving specific groups and operating in developing countries are considered.[7] These groups often have direct and indirect connections to NGOs, philanthropic foundations, labor unions, and other groups headquartered in the First World that provide all manner of support, including funding, technical expertise, and organization guidance.[8]

[6] Hollender, J., & Fenichell, S. (2004). *What Matters Most: How a Small Group of Pioneers is Teaching Social Responsibility to Big Business, and Why Big Business is Listening* (p. 49). Basic Books.

[7] For one resource, see the Duke University Non-governmental Organizations Research Guide: http://docs.lib.duke.edu/igo/guides/ngo/define.htm

[8] For an excellent discussion of the breadth of corporate campaigns see Manheim, J. B. (2001). *The Death of a Thousand Cuts: Corporate Campaigns and the Attack on the Corporation.* Mahwah, NJ: Lawrence Erlbaum Associates.

Social-investment groups – which often work in concert with CR, environmental, human rights, and other advocacy groups linked to the billion-dollar protest industry – file hundreds of shareholder resolutions annually (e.g., some 350 in 2005). These resolutions are often part of broader campaigns involving a range of tactics and goals. The specific topics of the resolutions vary each year, but they generally encompass typical progressive concerns including global warming, human rights policies, use of genetically modified ingredients, corporate governance, and more.[9] Other significant influencers include left-leaning pension funds including the mammoth California Public Employees' Retirement System (CalPERS), the nation's largest, which leverages its substantial voting power in an effort to influence board makeup and other issues at hundreds of corporations.[10]

Despite the growing role of NGOs in CSR and SRI it is not clear that corporate executives understand the influence that these groups can have on their freedom to operate. A 2005 Economist Intelligence Unit study indicated that executives place a very low priority on NGOs and local communities. A paltry 1% of executives surveyed around the world felt that NGOs were a priority while local communities garnered just 5%. In addition, despite growing attention generally being paid to the issue, the research found that for many, CR is something that is done to appease advocacy-group campaigns for the environment, human rights, and the like. Indeed, some seem to view it as an insurance policy: "We make toys, we're in a very public arena and we have a sensitive consumer base. It's a type of insurance policy. We are trying to avoid any [bad] event," a Mattel company official said.[11] Particularly for high-profile companies that seek to be seen as being socially responsible, there is often little they can do to insure themselves against being targeted.

"A Process with No End"

Thus far the campaign-based strategy of much of the CSR/SRI industry has succeeded because consumers and opinion leaders have largely accepted this industry's positions, premises, and related anti-corporate filters without question. Research has found that opinion leaders, who by definition have significant influence on public perception, are even more inclined than the general public to treat corporations they view or are presented as being irresponsible punitively. An international poll by the Environics research firm found that

[9] A list of current shareholder resolutions can be found at www.iccr.org.

[10] http://www.mallenbaker.net/csr/nl/39.html#anchor594 "Pension Funds Push Big Business to Go Green" and http://marketplace.publicradio.org/shows/2004/05/21_mpp.html

[11] *The Importance of Corporate Responsibility*, white paper from the Economist Intelligence Unit sponsored by Oracle, 2005.

as consumers, opinion leaders are 50% more likely than the general public to "punish socially irresponsible companies" than they are to punish corporations presented or perceived to be irresponsible than reward those known for doing good.[12]

The largely negative atmosphere is further muddied by a lack of universally agreed-upon standards for social responsibility. Beyond a general consensus on goals such as sustainability in the environment (a term which environmental advocacy groups have largely succeeded in co-opting); incorporation of ethical business practices and procedures; and compliance with federal laws and regulations, corporations have little to guide them: as of yet there is no governing body that specifies, for example, what defines environmental sustainability or emissions targets; what percentage of women and minorities should comprise corporate boards or what percentage or amount of annual earnings or sales should be returned to the community in philanthropy.

Corporate executives are increasingly calling for a common rulebook. "We need to have one homogenized global standard that can be applied around the world – the same standard everywhere," Jim Thompson of Hong Kong-based moving company Crown Relocation told The Economist.[13]

CSR industry observers including George Washington University Professor Jarol Manheim suggest that calls such as Thompson's may not soon be answered as it would be anathema to corporate antagonists. The lack of definitions and standards is by design, Manheim argues, to create a treadmill of perpetually increasing demands that makes achievement of a measurable mantle of social responsibility unattainable while continually increasing the power and influence of CSR/SRI industry-related advocacy interests.

Under these circumstances it is next to impossible for any company, no matter how responsible, to measure up across the board. "These days, investors have a hard time telling the good guys from the bad guys. … Who is credible," inquired the Toronto Globe & Mail newspaper. "Whose agendas are these (CSR/SRI) groups representing? For investors and other stakeholders, the answer lies in a credible CSR accreditation system. Until then, we are all adrift when it comes to judging responsible corporate performance …"[14]

The notion of the moving target extends even into groups considered to be supportive of corporate CSR efforts: San Francisco-based Business for Social Responsibility, generally viewed as a pro-corporate CSR/SRI trade organization, lists its mission as being "to create a just and sustainable world by

[12] Environics (2001). *Corporate Social Responsibility Monitor*.

[13] *Op. cit.*, *The Economist*, The Importance of Corporate Responsibility, p. 11.

[14] Toronto Globe & Mail, August 9, 2001.

working with companies to promote more responsible business practices, innovation, and collaboration."[15] Among BSR's blue-chip members (and frequent CSR/SRI targets) are Coca-Cola, Gap Inc., Monsanto, ExxonMobil and Ford Motor Company.[16] These and other companies might be surprised to hear a rather different interpretation of BSR's mission from Ben & Jerry's co-founder Ben Cohen, a founding member of BSR and a frequent proponent of and contributor to causes that are linked to anti-corporate campaigns. Cohen describes BSR's mission as "bringing big business to the table, and then moving the table."[17]

As Dave Stangis, CR manager for Intel notes, the key to understanding involvement with CSR/SRI groups is "knowing that it's a process with no end."[18]

Corporate "Best" = Advocacy Group "Worst"

The absence of set criteria also opens the door for anti-corporate campaigners, whose "worst" and shareholder-resolution lists are curiously similar to the "best" lists reported by public pollsters and mainstream media including Fortune, Forbes, and others. Fortune's 2005 list of the 100 most admired companies includes in the top 10 no fewer than seven companies that are perennial shareholder activism targets. Those celebrated – and targeted – include Wal-Mart, General Electric, Dell Computer, FedEx, Microsoft, Starbucks, Johnson & Johnson, and Procter & Gamble.

Of Fortune's 2005 10 most socially responsible corporations, eight have been blacklisted by SRI industry screens and five have been targeted with shareholder resolutions. The Table 10.1 shows a breakdown of those 10 and the reasons for their exclusion.

These similarities are not likely coincidental. Members of the SRI industry make no bones about the fact that companies that are good at what they do can quickly become targets. "It's our belief that if we can influence the large players it may be a model for others in industry," said Vidette Bullock Mixon, the director of corporate relations and social concerns for the General Board of Pension and Health Benefits of the United Methodist Church, a major player in SRI. "Corporations are responsible not only to their stockholders, but to their stakeholders and the Earth."[19]

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[15] Available at http://www.bsr.org/Meta/about/Mission.cfm

[16] An illustrative list of BSR members is found at http://www.bsr.org/Meta/MemberList.cfm

[17] *Op. cit.*, p. 14.

[18] Hollender, 2004, p. 74.

[19] SRI in the Rockies (2002). October 17–20.

Table 10.1 Fortune's 2005 10 Most Socially Responsible Corporations

Company	Fortune social responsibility rank	Sample SRI industry action
United Parcel Service	1	Shareholder resolution
CHS (Food wholesaler)	2	
Kinder Morgan Energy Partners	3	Shareholder resolution
FedEx	4	Shareholder resolution
Alcoa	5	Environmental screen Shareholder resolution
Starbucks	6	Shareholder resolution
Fortune Brands	7	Alcohol screen
Anheuser-Busch	8	Alcohol screen shareholder resolutions
BP	9	Environmental screen
Altria Group	10	Tobacco screen shareholder resolutions

Starbucks: The Cautionary Tale

> "We are targeting Starbucks, rather than (any other coffee company) because they are a high-profile market leader and because they promote themselves as socially responsible …"
>
> Ronnie Cummins, National Director, Campaign for Food Safety (formerly Pure Food Campaign).[20]

Total coffee purchases by Starbucks – just 1% of bean purchases worldwide – are dwarfed by those made by giant coffee buyers such as Sara Lee, Nestlé, Procter & Gamble and Kraft Foods. Why then do advocacy groups like the Organic Consumers Association (an industry-funded advocacy group whose publicly stated aim is to promote organic consumption and help poor coffee farmers around the globe), target their campaigns at Starbucks rather than their bigger, more important counterparts? The answer is simple: Starbucks' opponents see it as an easy target whose marketing relies in part on public perceptions that it is a good corporate citizen.

Since its foundation in 1985, Starbucks has cast itself as a socially responsible company, with programs that include supporting the humanitarian nonprofit group Cooperative for Assistance and Relief Everywhere (CARE) and offering stock options even to part-time employees. The company is regularly

[20] Dow Jones, *Protest Starts Against Starbucks On Fair-Trade Coffee North America*, Europe, September 18, 2001.

listed as a top socially responsible company, repeatedly making Fortune's list of the 100 best companies to work for, among others.

In what the Organic Consumers Association (OCA) took as a nod to outside pressure, the company began purchasing more than 1 million pounds of coffee produced under Fair Trade guidelines, an advocacy-group favorite, at more than twice the price Starbucks would otherwise pay. Unfortunately for Starbucks, no good deed goes unpunished. Rather than commend the company for steps in the right direction, Organic Consumers proclaimed victory and – relying primarily on the Internet – organized nationwide campaigns further demanding absolute concessions that Starbucks serve 100% organic milk, coffee and other products.[21]

In response, Sue Mecklenburg, Starbucks' vice president of CSR and business practices, conceded, saying that her company would offer organic and soy milk; offer an organic coffee of the day; promote Fair Trade coffee on college campuses; and feature it as "coffee of the day" once a month. OCA fired back that "these efforts have fallen short of what Starbucks customers expect of a company that which has prided itself as being at the forefront of social and environmental responsibility," and that it would not only continue its campaigns, but would increase its efforts, targeting Starbucks shareholders.

"Imagine a press conference where we stand outside a Starbucks location and test your Cappuccinos for the presence of rBGH" (a productivity supplement also called rbST which is not approved for use in the production of organic milk) OCA director Ronnie Cummins wrote, despite the fact that no such testing procedure even exists.[22] Cummins went on to demand that Starbucks cease using genetically modified ingredients also prohibited by organic standards in its baked goods, feature Fair Trade coffee as "coffee of the day" on a weekly basis, and use "independent" third-party Fair Trade and organic verifiers.

Organic certifiers and Fair Trade verifiers do not provide these services out of the goodness of their hearts, at least not exclusively. Instead they have a very real for-profit agenda that stands to gain from campaigns such as this. In fact, some outspoken activists directly own or are otherwise involved with the organic food and Fair Trade certification businesses.

Ronnie Cummins, a paid consultant on organic issues and the OCA campaign against Starbucks, receives support from Genetically Engineered Food Alert, a coalition of advocacy groups including the Institute for Agriculture and Trade Policy (IATP). IATP President Mark Ritchie helped found TransFair

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[21] Available at http://www.organicconsumers.org/starbucks/

[22] According to the U.S. Food and Drug Administration and the American Medical Association there is no test to determine whether milk is from bST-supplemented cows. FDA, AMA, and others report that milk from supplemented cows is the same, as all cows' milk naturally contains traces or bST which is indistinguishable from rbST. These organizations report that use of supplemental bST does not alter milk and dairy products in any detectable manner.

USA, which currently offers the only widely recognized seal of approval for Fair Trade coffee in the United States. In addition, Ritchie's organization owns a for-profit organic and Fair-Trade coffee company of his own, Peace Coffee a.k.a. Headwaters, Inc.

While OCA and its partners clearly have an interest in organic milk, it appears Starbucks customers are not as devoted. In early 2005 the company began removing the milk from its menus based on lack of demand. The Starbucks hotline and stores in St. Louis, Denver, Washington, DC, and Chicago reported that only a handful of customers were ordering organic milk for their drinks, despite the fact that Starbucks chose to absorb the additional expense and charged the same as conventional milk. Previous references to the organic milk program also were removed from the Starbucks web site.

Uneven Playing Fields

Apparent conflicts of interest are not uncommon in the world of social advocacy, a troublesome thought in an industry that has taken on the role of standard-setter. What is even more troublesome, though, is the research shows that in some quarters these tactics are accepted and even expected.

The Environics poll confirmed that often the playing field is not level between large corporations and the social-responsibility-related NGOs that often oppose them. People do not expect NGOs to operate cleanly, Environics found, and in fact see nothing wrong when NGOs turn to ethically questionable tactics, noting that "four in ten respondents expect NGOs to break some rules while pursuing their mandate … They (NGOs) cannot take for granted that they have a license to operate outside of societal bounds, especially in wealthy countries."[23]

Compounding the situation is a continuing decline in trust of established institutions such as government, the news media, and business. The Edelman Trust Barometer, a global survey of 1,500 opinion leaders, found that trust is shifting away from established institutions and towards a broad spectrum of peer groups, including NGOs. "The trust void in institutions – business, government, media – is being filled by NGOs, whose trust ratings have trended up in the United States, from 36% in 2001 to 55% in 2005. NGOs now are the most trusted institution in every market except China."[24]

Corporate Campaigns: A Tangled Web

In its response to The Economist's special section on CSR, Business for Social Responsibility said the magazine "mistakenly or willfully conflates a small

[23] Environics (2001). *Corporate Social Responsibility Monitor.*

[24] Available at http://www.edelman.com/news/allnews.asp

'anti-capitalist' minority that has sought to co-opt CSR, with the very real work done by corporations and their stakeholders who understand, promote, and embrace the power of capitalist enterprise."

BSR is correct that anti-capitalist groups have sought to co-opt CSR, but the suggestion in its statement that the group is small – and therefore of limited power or import – is mistaken and something that corporations ignore at their peril.

Advocacy groups, their funding sources and public relations firms have established strong footholds in the CSR and SRI industry. All of these groups are intertwined in complex networks of funding and influence that can make it difficult to quickly appreciate the financial, organizational, and reputation-influencing power that lies behind them. A project that appears initially to be the effort of one person or group can actually have funding and influence behind it that would rival that of most major corporations.

As Jarol Manheim explains:

> A corporate campaign is a wide-ranging campaign of economic, political, legal, and psychological warfare waged against a corporation's reputation. It is carefully targeted against the key stakeholder relationships – with customers, employees, shareholders, bankers, regulators, the general public, and so forth – upon which any company depends for survival. The objective of the corporate campaign is to tarnish the reputation of a company and undermine confidence in its management to the point where the company's customary partners and allies become its antagonists, and where the business environment in which it operates becomes so hostile that management is forced to change the company's policies … to make the pain go away.[25]

Shareholder resolutions and social investing play a key role in those campaigns, and just as larger corporate campaigns are well-organized, so in many cases are shareholder-resolution campaigns. While these shareholder resolutions cover a myriad of topics, SRI industry representatives agree ahead of each shareholder-resolution season on the larger themes that will be the focus of their advocacy for that period. For 2005, for example, major themes of some 350 resolutions filed by the Interfaith Center on Corporate Responsibility, a coalition of 275 religious and social investors, included health care, corporate governance, human rights, and global warming.

In creating the campaigns, issues – and the companies that are considered to be contributing to them – are often cast broadly, adding to their campaigns' legitimacy. For example, resolutions were filed in 2005 on global warming issues in six broad industry sectors (electric power, oil & gas, automobile, real estate,

[25] Manheim, J. B. (2000). *Corporate Conduct Unbecoming: Codes of Conduct and Anti-Corporate Strategy*. St. Michaels, MD: Tred Avon Institute Press.

financial services/insurance, and manufacturing), some apparently more directly related to the issue than others. Groups filing the resolutions also covered a wide swath of investors: four public institutional investors, a labor union, three foundations, nine SRI firms, and a host of religious institutional investors.[26]

Case Study: Rainforest Action Network

Much of the discussion of corporate campaigns may now be familiar to Citigroup, which has lived the experience in spades. When Citigroup announced in January of 2004 that it was adopting an environmental investment policy placing stringent standards for investments related to "endangered ecosystems, illegal logging, ecologically sustainable development, and climate change"[27] observers might reasonably have assumed that the program would bring an end to related environmental-advocacy-group campaigns against the financial institution.

Indeed, the San Francisco-based Rainforest Action Network (RAN), which had spearheaded a 4-year effort focusing on issues including protection of rainforests and indigenous people, climate change, habitat loss, and other environmental issues, was effusive in its praise: "Citigroup has articulated the strongest environmental policies yet of any private financial institution in the world," RAN Executive Director Michael Brune said in a joint Citigroup-RAN news release. "This moment marks a milestone in worldwide movement to stop global warming and deforestation. We overstate the importance of changing such a vast enterprise and look forward to working together with Citigroup in the coming years."[28]

Perhaps the "working together" part was a red flag: Barely 2 weeks after this announcement the World Wildlife Fund, a frequent RAN campaign ally,[29] was back at it, this time charging that Citicorp was funding an oil pipeline that would damage sensitive wetlands in the Caucasus.[30]

In addition, RAN used Citigroup as a weapon by leveraging its self-described "victory" to pressure Bank of America (which also ultimately acquiesced), JP Morgan, and other financial institutions to not just meet, but now exceed standards set by Citigroup. The campaign included an online tool that

[26] Available at http://www.institutionalshareowner.com/news/article.cgi?sfArticleId=1642

[27] The policy can be found at http://www.citigroup.com/citigroup/environment/gcibpolicy.htm

[28] Rainforest Action Network and Citigroup Announce Enhanced Citigroup Environmental Policy (2004). Found at http://www.citigroup.com/citigroup/press/2004/040122a.htm, January.

[29] RAN's web site (http://www.ran.org) includes articles noting WWF's efforts on efforts involving international logging, protection of mahogany forests, rainforest protection, and others.

[30] WWF says Citigroup, World Bank to Fund Disaster in Waiting World Wildlife Fund news release, February 9, 2004.

allowed campaign supporters to e-mail a veiled threat directly to the CEOs of John Hancock, Goldman Sachs and Wells Fargo:

"In January of this year, Citigroup, the world's largest financial institution, became the world's first major bank to commit to a global policy addressing the crisis in the world's forest and climate. I see no evidence that your company is taking into account the health of our global environment in your business and investment decisions," the letter warns before listing a series of steps the banks should take, including supporting indigenous populations, prioritizing alternative-energy funding and banning new funding for coal. "Please, do the right thing and face this historic challenge with resolve and determination. The world cannot afford to wait much longer, and a frustrated public, including myself, is growing increasingly impatient with your lack of action."[31]

The Battle Rages On

There are indications that the pressure on Citigroup will remain. Even though RAN announced a new cease-fire in January 2004, more than a year later the information about the campaign was still found on the organization's web site and the company was facing a new round of shareholder resolutions, this time related to CEO compensation. In a sense, the campaign never ended. Despite the RAN truce, other ethical investing groups continued to target Citigroup on a variety of issues, thus amplifying and perpetuating the negative messages laid out by RAN and others. The Shareholder Action Network noted on its web site in 2004, for example, that while a shareholder resolution against Citigroup on predatory lending was withdrawn "with the hopes of further progress on the issue this year," supporters are still encouraged to tell Citigroup "to take action against unfair lending practices."[32]

RAN's communications coordinator, Toben Dilworth, meanwhile also moved quickly to ensure the campaign would continue. In a news release on the Bank of America policy from social-investment advocate SocialFunds.com and distributed on the RAN, CSRwire, Calvert Funds, and other SRI-related web sites, Dilworth stated that the Bank of America policy exceeded Citigroup in "three distinct areas," and promised further action against banking institutions: "We recognize that currently, as much as the policies are progress, they are clearly not enough to confront the magnitude of the problems facing us – there are many areas where we will be continuing to press for significant changes," he said in the release.[33]

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[31] Available at http://action.ran.org/action/index.asp?step=2&item=14634

[32] Available at http://www.shareholderaction.org/action.cfm

[33] Available at http://www.ran.org/news/newsitem.php?id=1006&area=home

The Money Behind the Message

Founded in 1985, RAN describes itself as a grassroots organization that relies on the work of its 30,000 or so members to protect the world's environment and more specifically the forests and the indigenous people who live in them. Financial institutions that support logging and other efforts that run counter to those goals are a natural target for the group's aggressive, anti-corporate campaigns.

In noting the success of the RAN campaign against Citibank, The Economist pointed specifically to the NGO's ability to get Citigroup's attention by "urging customers to cut up their Citicards and plastering the Internet with nasty jibes against named executives."

"Not bad for a group with a dozen staff and a $2 million budget," the magazine added.[34]

That figure, which is impressive enough on its own, does not include the budgets of the many groups that make up RAN's supportive network. Among the group's financial supporters are many of the top foundations and institutes in the protest industry, including the Tides Foundation, the World Resources Institute, the W. Alton Jones Foundation, and companies including the progressive credit card and phone company Working Assets (a Citibank competitor and a project of Tides' President Drummond Pike), and more.[35]

Pension Funds: The Hunters and the Hunted

Within this highly scrutinized environment, public pension funds find themselves in the unusual position of being both major players in pushing for change in corporate governance and the target themselves of pressure from CSR/SRI groups that want to direct the pension funds' investments to increase pressure on targeted companies.

On the one hand, pension funds, working both individually and in groups, have led charges on many of the same campaigns followed by others in the social investing industry, for example, pressuring the Securities and Exchange Commission to require companies to disclose information on climate change risk.[36] Because the funds have so much financial power – U.S. state and local pension funds have more than $3 trillion in assets – by purchasing significant

[34] Living with the enemy. *The Economist*, August 7, 2003.
[35] Manheim, J. B. (2004). *Biz-War and the Out-of-Power Elite: The Progressive-Left Attack on the Corporation.* Mahwah, NJ: Lawrence Erlbaum Associates.
[36] Available at http://www.socialfunds.com/news/article.cgi/article1396.html

amounts of stock they are virtually assured of at least getting consideration from the federal agencies, corporations, and others they target.

Often they are successful in their campaigns. One high-profile 2004 case highlighted pension fund involvement in the ouster of Disney CEO Michael Eisner, in which funds including CalPERS (leveraging its nearly 10 million shares of Disney stock) withheld their support for the embattled chairman due to discontent over the company's performance and Eisner's ability to manage the company virtually unchecked due to his position as both CEO and chairman of the board. CalPERS was joined in the effort to oust Eisner as board chair and call for divided CEO and chairman positions by funds including the New York State Pension Fund and funds from at least six other states. Ultimately Eisner was stripped of his board chairmanship and two CEO and board chair positions were separated.[37]

However, those successes come at a price. CalPERS has been accused of cronyism for making unprofitable investments that advance causes that are favorites of Democrats and labor unions, both of which are heavily represented on the fund's board of trustees.[38] The group's close ties to labor and concerns that CalPERS was putting ideological priorities ahead of revenue generation are commonly believed to be the thinking behind the firing in December 2004 of Sean Harrigan, who had led the $177 billion fund since 1999.[39]

Pension funds have also been targeted by groups protesting the stocks they hold. TIAA-CREF, the nation's largest retirement fund with $330 billion in assets, faces ongoing actions from the Make TIAA-CREF Ethical coalition. As such TIAA-CREF is coming up against some key players in the billion-dollar protest industry, including groups associated with powerful labor unions including the Steelworkers and anti-corporate campaigner Corporate Accountability International, the former Infact. Using various channels on the Internet (web sites, e-mail, online news releases, etc.). Make TIAA-CREF Ethical has called on TIAA-CREF to "pressure corporations to be more socially responsible – and to divest from companies that refuse to change their practices."[40]

A recent campaign action alert put TIAA-CREF in the same place many of its corporate holdings have found themselves. The Make TIAA-CREF Ethical

[37] See California pension group opposes Eisner re-election. *Orlando Business Journal*, February 10, 2005. Available at http://orlando.bizjournals.com/orlando/stories/2005/02/07/daily33.html. See also La Monica, P. R. (2004). Eisner out as Disney chair. *Money Magazine*, March. Available at http://money.cnn.com/2004/03/03/news/companies/disney/ and More funds to withhold support from Eisner. *USA Today*, February 27. Available at http://www.usatoday.com/money/media/2004-02-26-disney_x.htm

[38] Calpers and cronyism. *Wall Street Journal*, October 18, 2004.

[39] Gadfly activism of retirement system chief could lead to his possible ouster today. *Wall Street Journal*, December 1, 2004.

[40] Make TIAA-CREF Ethical/Campaign for a Commercial-Free Childhood e-mail. February 2005.

campaign called on supporters to pressure the fund to divest some of its holdings, including Coca-Cola and Altria and to further push TIAA-CREF on a laundry list of favorite advocacy issues:

> CFCC (The Campaign for a Commercial-Free Childhood) and make TIAA-CREF Ethical are urging TIAA-CREF to pressure Coca-Cola to change their marketing practices. In the midst of an epidemic of childhood obesity, Coca-Cola continues to target children with their products. Despite their claims that they do not advertise to children under twelve, Coke designs toys for young children, markets their products extensively in schools to children of all ages, and its product placement is ubiquitous on programs like American Idol, the number one rated show for children. Coca-Cola lobbies extensively against policies that would help combat childhood obesity (such as prohibitions on vending machines in schools) and even denies that soft drinks are contributing to health problems for children. Currently, TIAA-CREF has substantial holdings in Coca-Cola.
>
> WHAT YOU CAN DO:
>
> Please take a moment to call TIAA-CREF CEO Herbert Allison at 800-842-2733 or 212-490-9000. Ask for Mr. Allison and speak to his assistant. (Calls are best, but you can e-mail HAllison@tiaa-cref.org.) If you have a TIAA-CREF account, let them know. Then urge TIAA-CREF to pressure Coca-Cola to end ALL marketing – including Coke toys, in-school marketing, and product placement – aimed at children.
>
> You may also be interested in other Make TIAA-CREF Ethical campaigns. While talking to Mr. Allison's assistant, please also consider urging TIAA-CREF to:
>
> * Support the proxy resolution of the New York City pension funds for an independent investigation of human rights abuse associated with Coca-Cola bottling plants in Colombia – and pressure The Coca-Cola Co. to agree to such an investigation.
> * Drop its stock in Philip Morris/Altria, which is responsible for thousands of tobacco-related deaths worldwide.
> * Pressure Nike and Wal-Mart to end sweatshop abuses worldwide; urge Wal-Mart to stop its destructive impact on local economies and close its Teotihuacan, Mexico store – or divest from those companies if changes are not made.

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* Urge Unocal to improve its human rights record in
Burma - or divest if changes are not made.
* Pressure retailer Costco to close its illegally
constructed warehouses in Mexico and end human rights
abuses - or divest.
* Pledge to buy no new World Bank bonds as long as
bank policies contribute to economic instability
around the globe-TIAA-CREF previously divested such
holdings.

For more information about these campaigns,
please visit http://www.maketiaa-crefethical.org/
organizations.html. And please forward this message
to friends and families with TIAA-CREF accounts.
Thank you, Josh Golin Action Coordinator CFCC
www.commmercialfreechildhood.org.[41]
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If TIAA-CREF were to consider heeding the call to dump the tobacco stock, it would do well to consider first the experience of CalPERS and its sister organization, the California State Teachers Retirement System (CalSTRS), which in 1999 divested $800 million of tobacco stocks, in part at the behest of California State Treasurer Philip Angelides. Since the sale the American Stock Exchange Tobacco Index has wildly outperformed the S&P 500 and the NASDAQ, costing California pensioners more than a billion dollars.[42]

Leveraging the Internet for Promotional Success

> "The Internet has become the latest, greatest arrow in our quiver of social activism. It benefits us more than the corporate and government elites were fighting."
>
> Mike Dolan, Public Citizen, *Journal of Public Affairs*, August 2002

As with other areas of communication, the Internet has become the central staging ground for all of the most important groups in the CSR/SRI industry, advocacy for and against pension funds included. Without the power of the Internet as a source for consumer and investor information, CSR/SRI issues and influence would be significantly limited. Environmental and social-cause advocacy has been particularly adept at leveraging the Internet's tools,

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[41] *Ibid.*

[42] Entine, J. (2004). U.S. pension funds, social investing, and fiduciary irresponsibility. *Ethical Corporation Magazine*, February.

recognizing in the online world an unprecedented platform from which to network with individuals and other organizations, spread information, and garner support for their shareholder resolutions and related campaigns.

For example, RAN ally and direct-action facilitator the Ruckus Society[43] (which is funded by Ben & Jerry's, The Body Shop, and Patagonia among others), holds Internet "Tech Tool Box Action Camps" that provide attendees with training and technical assistance from Working Assets Funding Services, Inc.[44] Working Assets reports annual sales of $140 million and donations since 1985 exceeding $40 million to groups like Greenpeace, RAN, and others who have targeted Working Assets' competitors with CSR-related campaigns. Working Assets also operates ActForChange.com, which sponsors "action alerts" and public comment tools for a wide range of advocacy campaigns, including corporate governance. Training camps, organizing manuals, and other materials help protest groups solicit new members, network with affinity groups, raise funds, and engage in various outreach activities with journalists, governments, and the public with a goal of further expanding their influence.[45]

SRI funds, meanwhile, use the Internet to put their social agendas and investing information at consumers' and investors' fingertips, as well as to promote their shareholder-resolution campaigns. Organizations such as the Social Investment Forum use the Internet as a clearinghouse for information on hundreds of SRI-type funds. Other sites provide detailed information on current and historical shareowner resolutions that include online forms for investor e-mails to the companies. Major SRI advocacy groups such as the Shareholder Action Network also provide web users the opportunity to "click here to send" a letter to the CEOs and other officials of corporations they are targeting.[46]

These groups and others acknowledge that the Internet has given them a heretofore unseen opportunity to make their voices heard. "It used to be you'd call 20 people you know on the telephone and ask them to write a letter or introduce a resolution on the next annual meeting," says SAN's Tracey Rembert. "Now you can bring together many more people with one e-mail. You can accomplish in 1 year what it might have taken 10 years of pickets and

[43] *Op. cit.*, Manheim. The Death of a Thousand Cuts: Corporate Campaigns and the Attack on the Corporation.

[44] Available at www.ruckus.com and Byrne, J. (2002). *Money, Marketing and the Internet: Key Factors Influencing Agricultural Biotechnology Public Acceptance.* American Enterprise Institute, June.

[45] White, C. (2000). *Environmental Activism and the Internet.* Massey University (NZ), February.

[46] An example from the ExxonMobil campaign can be found at http://www.shareholderaction.org/action_detail.cfm?action=e&id=11&letter=I

protests in the streets to accomplish."[47] The Internet is also an important tool for pension funds, which use their web sites to communicate to pension members and others about their campaigns, proxy votes, and more. "The web has dramatically altered the landscape, allowing dissatisfied shareholders to find each other and together issue a much more powerful statement," notes Michael Flaherman, chair of CalPERS Investment Committee.[48]

CSR/SRI Backlash: Three Cases

At the same time as proponents of social investing tout record numbers of shareholder resolution filings and higher percentages on proxy votes at corporate annual meetings, in some cases the anti-corporate elements of the CSR/SRI industry have prompted a backlash.

BERKSHIRE HATHAWAY: Proponents and practitioners of corporate philanthropy lost an important ally in July of 2003 when Warren Buffett's Berkshire Hathaway terminated its charitable giving program. Buffett and his board decided to end the program following an attack by a pro-life advocate who was upset by what she described as Berkshire Hathaway and Buffett's donations to pro-choice causes.[49]

The campaign was begun by Cindy Coughlon, an active member of Arizona Right to Life who used her side job selling Berkshire's Pampered Chef cooking products to pressure Berkshire Hathaway and Buffett to stop contributing to pro-life causes. Coughlon worked with other pro-life groups and her supporters to leverage the Internet to amplify the campaign through articles placed on web sites, e-mails sent to Pampered Chef, and more. Coughlon complained that Berkshire Hathaway and Buffett supported abortion and began an Internet campaign against them. While the company had been the target of related shareholder resolutions and other attacks in the past, Buffett reportedly could not tolerate that the most recent flap was damaging the reputation of Pampered Chef and its sales representatives, and ultimately determined that the program should be shut down.[50]

The decision brought to an end some two decades of philanthropy by Berkshire Hathaway. During that time Berkshire, at the direction of its shareholders, donated nearly $200 million to a wide range of institutions including

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[47] Schapiro, M. (2001). All over the board – Internet/web/online service information. *The Industry Standard*, February. Available at http://www.findarticles.com/p/articles/mi_m0HWW/is_2001_Feb/ai_70909256.

[48] Ibid.

[49] Berkshire gives up on giving: how a pro-life housewife took on Warren Buffett. *Fortune*, July 21, 2003.

[50] Ibid.

organizations representing both sides of the abortion debate.[51] Ironically, it could be argued that the big losers in the decision were not Buffett himself, but Berkshire Hathaway's shareholders, who through the investment program had been allowed to earmark $18 per share annually for up to three charities of their choice. Also losing of course were a significant number of institutions that had benefited from Berkshire's contributions over the years. According to Berkshire, some 3,500 organizations including Creighton University and the University of Nebraska had benefited from the program over the years.[52,53]

NIKE: One of the most closely watched court cases related to CSR was a lawsuit filed in 1998 in which California labor rights campaigner Mark Kasky sued Nike for false advertising over comments it made in its CSR report about working conditions in its overseas manufacturing plants. At issue was whether the report was considered "free speech" and therefore was protected under the First Amendment as Nike argued, or whether it was "commercial speech," as Kasky contended, and therefore subject to litigation. The case went all the way to the U.S. Supreme Court, which refused to rule on the California High Court's judgment in favor of Kasky. The action ended in a settlement in 2003 with Nike agreeing to pay $1.5 million to the Fair Labor Association, a Washington, DC-based non-profit.

While the legal wrangling ended there, Nike responded by announcing that it was suspending its social reporting until the legal issues could be resolved. It issued its last CSR report in 2001 and announced in early 2005 that it planned to resume reporting. Despite the resolution of the situation, the precedent set by the case about reporting remains. Noted Kirk Stewart, Nike's then-vice president of corporate communications, the case is precedent-setting because of the possibility of more legal actions against public disclosures. "It puts not only us but any company that sells a product or a service in the state of California in a position where they have to balance the need to communicate and be transparent with the risk of litigation," he said.[54]

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[51] Ibid.

[52] Berkshire Hathaway news release, July 3, 2003, Omaha, Nebraska. Available at http://www.berkshirehathaway.com/news/jul0303.pdf

[53] The move resulted in significant backlash against Coughlin in online discussion and resulted in numerous posts to online spaces such as weblogs and discussion groups. One poster called the move "A classic example of cutting off your nose to spite your face. Berkshire Hathaway gave away $200 million across ALL charities, a small fraction of that going to pro-choice groups. So, the 'activists' make such a stink that instead of trying to sort it all out (Berkshire Hathaway) just (discontinues) the program. I hope this woman is proud of what she REALLY did, which was end one of the most generous philanthropic ventures in our country." Available at http://www.metafilter.com/mefi/27144

[54] Maitland, A., & Murray, S. (2004). The trouble with transparent clothing. *Financial Times*, May 12.

And at least some observers predicted the lack of a clear resolution will have repercussions in the world of corporate philanthropy: "Fear of the possible consequences of disclosure is often a big factor for companies on the brink of reporting," said Mallen Baker of the U.K.-based consultancy Business in the Community who writes frequently on CSR issues. "So far, it has been more or less true to say that companies do not suffer negative consequences from honest disclosure – only from covering up. If everything that companies say is to be evaluated on different, more restrictive rules to what anyone else might say, then even honest disclosure becomes a risky business."[55]

CINTAS: Perhaps the biggest corporate line in the sand was drawn by uniform maker Cintas, which sued the leader of one of the groups that filed a shareholder resolution against it alleging he made defamatory remarks against the Cincinnati-based company. Cintas charged in its lawsuit that Timothy Smith, senior vice president of SRI firm Walden Asset Management, defamed the company by linking it to a Haitian sweatshop in remarks he made at the company's annual meeting in October 2003. Smith was speaking in favor of a shareholder resolution it filed along with Domini Social Investments calling on Cintas to verify compliance with its code of conduct and by its factories and suppliers. Cintas sought damages and to bar Walden from making further claims linking Cintas to sweatshops. "If you are going to make allegations as a fact, those can be very damaging to a company in today's environment," Cintas spokesman Wade Gates explained to The Associated Press.

The SRI community was outraged: "We have the right to question management and this is a bullying tactic to quiet that," said Joanne Dowdell, director of CR at the SRI firm Citizen Advisers. "This could create a different atmosphere at meetings by restricting the free flow of shareholder comments." Christopher Wolf, a Washington, DC attorney who has supported SRI campaigns in the past, was more resolute, hinting that such actions could create more problems for companies than they solve: "Companies could be liable for filing frivolous cases," he said.[56]

The Cintas litigation was eventually settled, with Smith apologizing and Cintas promising to issue the report the shareholder resolution had sought. Despite the ultimate settlement, when taken with Warren Buffett's move to withdraw from the philanthropic field and the Nike settlement and subsequent decision against social reporting, it seems clear that the stakes and the temperature in CSR/SRI have been raised significantly. Those with the most at stake here, though, may be the many non-profits that rely on corporate contributions for their very survival and the corporations whose primary reason for getting involved in CSR was to do the right thing.

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[55] Available at http://www.socialfunds.com/news/article.cgi/article957.html

[56] *Speaking Out Could Get Investors Sued.* The Associated Press, April 9, 2004.

CSR/SRI and Profitability: Absolute, Definitive Proof … of Ongoing Debate

While the media spotlight continues to shine on CR and ethical investing, a variety of research in recent years has challenged the common perception about the "business case for CSR," which argues that CSR is both good and good for business.

In one of the most recent examinations of CSR/SRI profitability, prize-winning economist Arthur Laffer studied companies ranked among the most socially responsible and found evidence of a negative effect of CSR on corporate profitability. Laffer, who is known as the father of "supply-side" economics, and his co-authors took issue with the numerous studies that have tested the relationship between CSR and profitability and found a likely positive correlation.

"Given that businesses are increasingly being pressured by social activists to undertake CSR initiatives, in part based on a claim that CSR initiatives enhance business profitability, we set out to determine whether that claim is supported by empirical data," Laffer wrote.[57]

Using a selected group of 28 companies that were included on Business Ethics magazine's list of the 100 most responsible companies each year from 2000–2004, Laffer tested whether being a socially responsible company had a positive, negative, or no effect on the traditional financial yardsticks of compound annual net income growth, average net profit margin and stock price appreciation.

"In each of the three profitability comparisons … only a minority of the 28 CSR-leading companies in each comparison outperformed their peers. Being a CSR-leading company was negatively or not correlated with compound annual net income growth, net profit margin, and stock price appreciation," the paper said.

Laffer and his co-authors were quick to caution, however, that the study was not intended to be a definitive analysis: "Our results, of course, do not conclusively prove that CSR initiatives have a negative impact on a business's financial performance. They are, however, strong evidence against the claim that CSR initiatives have universal or systematic positive financial impacts on companies. Perhaps the most that can be said at this point is that research in this area should continue."

Laffer and company's paper was quickly followed by an impressive pronouncement by the CSR/SRI advocates at Business Ethics: "Holy Grail

[57] Laffer, A. B., Coors, A., & Winegarden, W. (2005). *Does Corporate Social Responsibility Enhance Corporate Profitability?* It can be found at http://www.csrwatch.com/CSRProfitabilityStudy.pdf

Found: Absolute, definitive proof CSR pays off," the magazine proclaimed, citing the results of two meta-studies that evaluated 30 years of research and 112 studies.

In particular, the publication cited a "rigorous and groundbreaking" meta-study covering 52 studies done over 30 years that "proved that a statistically significant association between corporate social performance and financial performance exists, which varies 'from highly positive to modestly positive.' "[58]

Possible explanations for the results, which have been put forward by other researchers as well, were that socially responsible companies may be better managed than those that are not, or that companies that do well financially have more to invest in socially responsible projects, which in turn may boost their bottom lines.

Corporate executives and industry observers appear unconvinced, however. Stephen Davis of Davis Global Advisors, one of the nation's foremost authorities on corporate governance says it is hard to verify the notion that a company that is more responsible is also better off financially. "It is really difficult to measure the bottom-line impact of CR. I have gone through plenty of data and there is not much correlation," he said.[59]

A similar debate rages on the profitability of SRI. Advocates of the approach, including ethical investing funds, frequently state that it is possible to invest in socially responsible companies and gain returns that are equal to or better than market averages. SocialFunds.com, an online social investing clearinghouse that provides information on corporate profiles, shareholder resolutions, and more, reported positive returns in 2004 for SRI mutual funds. The group reported that of the broadly-screened SRI mutual funds it tracks, two earned returns above 20% and six others outperformed more than 80% of their SRI and non-SRI peer funds.[60]

However, empirical studies by other observers of SRI have concluded essentially the opposite, that a socially screened investment portfolio at best offers no additional financial benefit to the investor. Those numbers may be affected in part by the higher administrative fees that some SRI funds charge (e.g., funds incur additional costs to screen investments and monitor companies), but regardless of the reason, the net effect appears to nil.[61] Other reports have argued more strongly that since the bust in the technology stocks that were held by major funds including Domini, Calvert, Citizens, and others, those

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[58] Holy Grail Found: Absolute, Definitive Proof CSR Pays Off. *Business Ethics*, Winter 2004.

[59] *Op. cit.* The Importance of Corporate Responsibility.

[60] *2004 Socially Responsible Investment Fund Performance*, January 3, 2005. Accessed at http://www.sri-adviser.com/article.mpl?sfArticleId=1611

[61] Munnell, A. H., & Sundén, A. (2004). *Social Investing: Pension Plans Should Just Say "No"*. American Enterprise Institute.

funds have significantly underperformed the stock market and their mainstream competitors.[62]

As with CSR, the SRI industry and those working to gauge its effectiveness suffer from a lack of established, across-the-board criteria for defining “ethical” companies against which all contenders can be measured. In addition, the screens and criteria traditionally applied to social investing (nuclear arms, gambling, alcohol, and tobacco) relate more to social matters than to core business-management issues and thus often ignore the factors that truly influence a company’s viability as an investment.

For the purposes of this discussion, however, the point is that there is sufficient confusion and lack of consensus that for public pension funds, carrying as they do the retirement incomes of millions of Americans, social investing is a significant risk, especially when it is not clear that there is any financial benefit to doing it.

Conclusion

The current environment for CSR and SRI is influenced by anti-corporate campaigners who use CSR and SRI tactics as weapons in their ongoing battle against corporations. Public pension funds have at times been pulled into these campaigns and have been pushed to make or drop investments based on non-financial criteria that do not necessarily mesh with what should be a core goal of guaranteeing a financial return for pension fund members.

At the same time, the evidence is not conclusive either that CSR programs benefit business profitability or that SRI results in greater financial returns than traditional investments.

As Boston College’s Alicia Munnell and Annika Sundén note: “It is dangerous in a politically charged environment to permit decision makers to deviate from the pursuit of maximum return for a given level of risk.” Pension funds “should not engage in activities that sacrifice returns for social goals; the pension fund is not an appropriate mechanism for gift giving.”[63]

Social investing leaders have indicated that they view pension funds and other institutional investing as important targets for the amplification of SRI principles.[64] Targeting public pension funds for these efforts would be a mistake. There is too much risk involved, particularly given the minimal financial return, to make gambling with the retirement income of millions of pensioners a good bet.

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[62] *Op. cit.*, Entine.

[63] *Op. cit.*, Munnell, Sundén.

[64] *Op. cit.*, Entine.

11

Why Social Investing Threatens Public Employee Pension Funds

Jon Entine

Public pension fund assets over recent decades have grown far faster proportionately than the assets of other significant investor categories. State and local government pension funds collectively hold almost $2 trillion in assets in approximately 2600 public pension funds. Another $897 billion is in held in federal retirement accounts.[1] The vast majority of these funds are defined-benefit plans whose main goal is to provide a specific level of retirement benefits to approximately 20 million members, which include general government employees, teachers, police, and firefighters, and retirees. These funds have fulfilled a very important role by providing for the retirement security of public employees.

Professional managers traditionally managed these funds almost exclusively, with little interference from state and municipal treasurers and other politicians who technically oversaw the funds. Few public pension funds incorporated social criteria. They were managed according to strict fiduciary principles designed to protect American workers and taxpayers. Although there were no formal legal constraints, using social or other non-fiduciary screens risked violating accepted standards of fiduciary responsibility. Because equity markets are relatively efficient over time, most money managers who would have been forced to draw from a shallower pool of stocks did not believe they could adequately diversify their investments and so avoided using social screens.

That tradition is now under challenge. Some of the largest state and municipal employee funds including in California, New York, New York City, Connecticut, and Minnesota, among others, now incorporate social, political, and ethical criteria rather than making decisions based solely on the potential for the best returns. In recent years, social activists and advocacy groups have allied themselves with union leaders and sympathetic politicians, introducing ideology into the management of public pension funds with a stated goal of

[1] *Employee Benefit Research Institute*, "Assets in Qualified Retirement Plans, 1985–2002: Revised" EBRI, Washington, D.C., September 2004.

more directly influencing corporate and public policy. For example, pension funds adopting social criteria might invest in favored local investments or publicly pressure management to change company policies, like those that deny health coverage to same-sex couples. It's been estimated that more than 20 percent of state and local government-employee pension systems have prohibitions against investment in companies that fail to meet certain social goals.[2]

There are three major concerns spurred by the growth of public pension funds: (1) the incorporation of social criteria will result in a lag of the investment performance of the public funds; (2) public funds are becoming increasingly active in the governance area and in social issues, which though admirable in the ideal, has become problematic in practice; and (3) public funds appear to be influenced by political motives.

Historical Context of Social Investing of Pension Funds

The use of social criteria by public pension funds is part of a wider movement known variously as "socially responsible" investing (SRI), social investing, or ethical investing. Only a few years ago, SRI was restricted to a relatively small number of activists who socially screened personal investments to reflect their political and social beliefs. In its broadest application, SRI advocates call for the boycott of so-called bad corporations: cigarette companies or arms manufacturers, for example. SRI later adopted positive screens to include corporations judged to have "progressive" social policies or "clean" environmental records—often technology, pharmaceutical, and financial firms.

Social screening has its origins in the beliefs of Colonial-era Quakers, who withdrew their business from companies involved in alcohol, tobacco or gambling for encouraging "sinful" behavior. These notions remain the backbone of most "sin screens" even today. The Quakers combined their ultra-conservative religious beliefs with a strong stand against slavery, initiating what is believed to be the first issue-specific screen resulting in boycotts of companies tied to the slave trade. The first externally screened US investment, the Pioneer Fund, established in 1928, incorporated negative religious screens, excluding companies involved in tobacco or alcohol.[3]

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[2] Entine, Jon, "U.S. Pension Funds, Social Investing, and Fiduciary Irresponsibility," *Ethical Corporation*, January 2004.

[3] For historical overview, see: Domini, Amy L., *Socially Responsible Investing: Making a Difference and Making Money,* (Chicago: Dearborn Trade Publishing, 2001); Waddock, S. A. and Smith, N., "Corporate Responsibility Audits: Doing Well by Doing Good," *Sloan Management Review*, 41(2), Winter 2000, 75–83; Hutton, B. R., and D'Antonio, L., Johnsen, T. (September 1998). Socially Responsible Investing. *Business & Society*, 37(3): pp. 281–304.

The social activism of the 1960s spurred the development of additional negative screens based on overtly ideological and political sentiments. In 1968, a pension fund in Boston asked a young securities analyst, Alice Tepper Marlin, to compile a "peace portfolio" of corporations with the least involvement in supplying armaments for the war in Vietnam. Hundreds of church and community groups asked for her report. The Interfaith Center on Corporate Responsibility composed of hundreds of religious members from varying faiths was formed in 1971. That same year, activist members of the United Methodist Church launched the Pax World Fund founded as the first broadly diversified, publicly available mutual fund to use social as well as financial criteria in its investment decisions. It included a negative screen on military contracting along with screens for alcohol and gambling. The founders, dedicated members of the anti-war movement believed "they could best influence corporations from the inside, as potential shareholders who might invest in a company if it met these standards."[4]

The 1970s and 80s witnessed the blossoming of a concurrent movement known as green or ethical consumerism. Advocacy consumer groups, many inspired by Ralph Nader, played a role in highlighting often-overlooked social and environmental problems, many of which were blamed on multinational corporations. A number of small, entrepreneurial businesses, such as Ben & Jerry's and The Body Shop, although beset by internal ethical contradictions and a gap between the progressive, if often inflammatory, rhetoric of their popular founders and their problematic operations, were often romanticized by activists as "socially responsible" entrepreneurial alternatives to multinational corporations.[5] These two essentially anti-corporate currents – socially conservative sin notions promoted by religious-oriented mutual funds and the vaguely liberal, consumerist brand of Sixties activist ideology – coalesced during the 1980s to form the core of what is today called social or ethical investing.

The catalyzing event for the SRI movement was the boycott of apartheid South Africa, which tapped into the sentiments of newly affluent baby boomers sympathetic to an anti-establishment anti-corporate ideology. Rising interest in social investing prompted the founding of SRI portfolio management firms including Franklin Research and Development in Boston (now Trillium Asset Management) and social investment companies such as the Calvert Group in Washington. By the late 1980s, socio-religious screens had conflated with populist but shifting activist concerns to form the hodgepodge that today constitutes the notions of the dominant liberal wing of social investing.

[4] "The History of Pax World," available from http://www.paxworld.com/history.htm, accessed March 5, 2005.

[5] Entine, Jon, Rain-Forest Chic: A Look at the Underside of Ethical Marketing, *Toronto Globe and Mail Report on Business Magazine*, October 1995, 12(4): 40+.

Although there is considerable disagreement among social investment professionals, firms engaged in arms manufacturing, nuclear energy, tobacco and alcohol production, animal testing, and those companies deemed to contribute to global warming or engage in genetic modification in agriculture are generally considered unacceptable. Stocks of public companies deemed to have poor records on these issues or in labor, environmental, or women's and gay rights policies are negatively screened out along with those corporations involved in heavy manufacturing and natural resources, which are marked as environmentally "messy".

KLD Research Analytics (co-founded in 1988 by Peter Kinder, Amy Domini, and Steven Lydenberg), which provides the social research for left-leaning social investors, originally established eight screening categories, later expanded to ten, constructed around negative or "exclusionary" screens: nuclear power, alcohol, gambling, tobacco, and military contracting, with other negative activities such as insensitivity to gays swept into an "other" category.[6] Companies that fail this initial sin screen are summarily excluded from various social indices based on the KLD data. After sweeping for negative concerns, KLD evaluates companies in qualitative areas such as community relations, workforce diversity, employee relations, environment, non-US operations, and product safety. KLD staffers assign numerical ratings for each company in each category, which become the basis for its hierarchical rankings. The highest rated companies are considered for investment in portfolios and are included in one or another index, including the Domini Social Index 400. Launched in May 1990, the DSI was the first benchmark for equity portfolios subject to multiple social screens and today remains the most prominent. Many academicians use as it as a benchmark index for the SRI industry. Many public pension funds rely on this data.

Although liberal advocates in the SRI community consider themselves voices for corporate reform, focusing on corporate governance and boardroom ethics, the data presented by the Social Investment Forum (SIF), the trade group that represents liberal social investors suggests that SRI remains dominated by the negative screens that reflect its ultra-conservative religious roots. The largest SRI fund included in the data, American Funds Washington Mutual with more than $65 billion in assets, has a limited screen for both tobacco and alcohol production. The SIF's most recent study, issued in 2005, reports that 64 percent of existing "socially responsible" mutual funds rely on one negative screen, tobacco, with alcohol second[7] (see Figure 11.1).

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[6] See www.kld.com/benchmarks/BMSImthd.html

[7] *2003 Report on Socially Responsible Investing Trends in the United States.* Social Investment Forum, Updated December 2003.

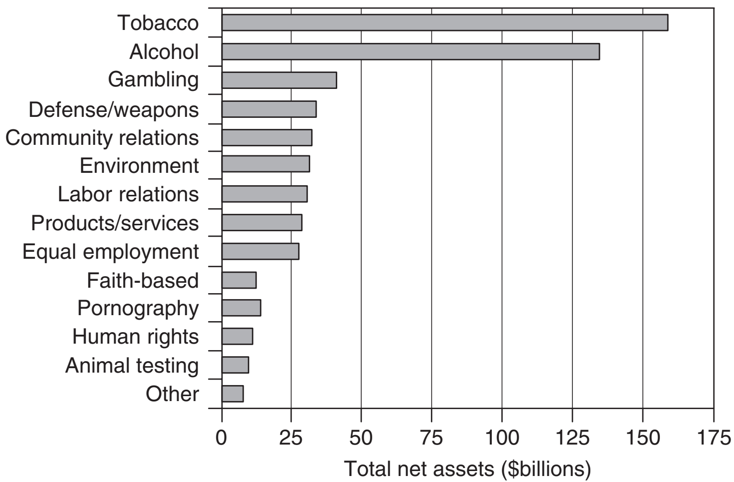

Figure 11.1 Mutual Fund Screen Types, 2005
Source: SIF. 2003 Report on SRI Trends in the U.S.

The Financial Footprint of SRI

The financial size of the social investing movement in the U.S. is unclear. Every two years since 1995, the Social Investment Forum (KLD, Domini Investments, Calvert Group, Parnassus, Citizens and other prominent liberal-oriented social investing groups and mutual funds are key members) has issued a report on industry trends including estimates of the assets of investors who use social screens and shareholder advocacy. In its December 2005 report, the SIF claimed social investing was enjoying "healthy growth" and that "$2.29 trillion … 9.4% of the $24.4 trillion in total assets under management … is involved in socially responsible investing."[8] However, the reliability of these claims is suspect.

The SIF compiles its numbers by counting all assets that, by its definition, are "screened, involved in shareholder advocacy, or are directed to community investing" – even if the client does not consider those investments socially responsible. It claims that the bulk of those assets, $1.5 trillion, is invested in "separate accounts," almost all of which are held by institutions such as public pension funds, universities, and unions that factor in social notions when making investment decisions. That figure is down sharply, by almost 25%, since the previous SIF report in 2003. Even a casual review of the data

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[8] *2005 Report on Socially Responsible Investing Trends in the United States.* Social Investment Forum, January 24, 2006, p. 6.

suggests even these numbers are inflated. Alicia Munnell and Annika Sundén of the Center for Retirement Research at Boston College noted in their analysis of social investing trends that the SIF counts Boston College as using social screens to invest its $1 billion endowment when in fact it has not screened investments for more than a decade.[9]

One-third of "socially responsible" assets represent money held by institutions that sponsor or co-sponsor shareholder resolutions on issues the SIF considers socially responsible. A large percentage of these resolutions involve corporate governance issues, which until recent years was considered a "non-issue" by KLD and not evaluated.[10] If an institution files a shareholder resolution, its assets under management are counted by the SIF as "socially responsible" – a questionable judgment. As a result, the overall "social investing" numbers are vastly inflated.

Screened mutual funds, which are what the public most commonly associates with social investing, represent only a tiny fraction of the overall figure. The SIF counted 151 socially screened funds at the end of 2005, down sharply from 178 in 2003. They held$179 billion.[11] Approximately 2.4% of the $7.5 trillion public non-money market mutual fund universe,[12] down sharply from 3.1% in 2003.[13] If the mutual fund market is fair measure, the financial footprint of social investing is tiny and shrinking; it's far smaller than its advocates claim and much less than its outsized reputation in academia and the media.

Do Socially Screened Funds Perform Competitively?

In the 1990s, during the extended bull market, self-labeled socially responsible funds performed competitively. The Domini Social Equity Fund (DSEFX), the popular index fund often used as a proxy for social investing, avoided stocks of underperforming natural resource and manufacturing companies, which many social investors believe are "dirty" because of their alleged adverse environmental impact. Favored SRI sectors – technology, communication, financial, and pharmaceutical stocks – did well. These returns fueled a spate of claims by SRI advocates. "There is a growing literature in academic

[9] Munnell, A. and A. Sundén (2005), "Social Investing: Pension Plans Should Just Say 'No'," *Pension Fund Politics* (p. 16). [Washington, D.C.: AEI Press]. 16.

[10] Focusing on non-issues such as independent boards, transparency and the like makes it easy to avoid taking stands on real issues of corporate accountability 2005, wrote Peter Kinder, November 13, 1997, Email to Social Investment Forum Mailing List.

[11] *2005 Report on Socially Responsible Investing Trends in the United States*, Social Investment Forum, January 24, 2006.

[12] *Monthly Mutual Fund Report.* Federal Reserve Bank of Boston, November 3, 2006, p. 2.

[13] Munnell, Alicia and Annika Sundén, "Social Investing: Pension Plans Should Just Say 'No'," *Pension Fund Politics* (Washington, D.C., AEI Press, 2005).

and professional investment journals that suggests socially responsible investing might produce higher risk-adjusted portfolio returns than merely using all available stocks in the equity universe, wrote John Guerard, a former portfolio manager"[14] In 2002, even as the market was contracting, Boston College Prof. Sandra Waddock, a vocal SRI proponent and consultant, wrote that "significant evidence from a large and growing body of academic research suggests at a minimum a neutral, and quite likely a positive, relationship between responsible corporate practices and corporate financial performance."[15] In 2004, the former editor of now defunct *Business Ethics* magazine, Marjorie Kelly, wrote a cover story entitled, "Holy Grail Found: Absolute, Positive, Definitive Proof CSR Pays Off Financially."[16] Recent returns suggest otherwise. As a group, "socially responsible" funds that use a broad array of social screens have performed mediocre. According to the ranking system compiled by *The Wall Street Journal*, the DSEX, which constitutes 250 S&P 500 stocks and another 150 medium-sized company stocks that pass its screens, rates a "D" for its 1- and 3-year performance and a "C" over 5 and 10 years, with an annualized return of 7.2%. Calvert's Social Equity Fund, which is technically not an index fund, rates an "E" for its 1- and 3-year performance, a "D" for 5 years, and a C over 10 years, with an annualized return of 8.6%.[17] The Calvert Social Index Fund has actually lost 2.21% since its inception in 2000, ranking it in the bottom 15% of all funds.[18] Some actively managed funds that use social screens, including those managed by Parnassus and Pax World, have performed well.

In retrospect, the competitive performance of SRI funds during the bull market might have had far less to do with the advantages of social screening and more to do with sector bets – outsized investments in high technology, communications, financial, and drug and health care stocks.[19] The DSEFX traditionally has overweighted, and still does as of October 2006, stocks of telecommunications, software, consumer goods, and consumer services companies – sectors, which performed extremely well during the bull market, but have lagged since 2001. By ideology, according to *Morningstar*, as of November 2006, the fund has dramatically underweighted – and still does – the

[14] Guerard, Jr., J. B., "Is Socially Responsible Investing Too Costly?" *Pensions and Investments 25*, February 17, 1997, 26; Camejo, P. (Ed.), *The SRI Advantage: Why Socially Responsible Investing Has Outperformed Financially*, September 2002 (Gabriola Island, BC, Canada: New Society Publishers).

[15] Waddock, S. A., and Bodwell, C., Graves, S. B. "Responsibility: The New Business Imperative," *Academy of Management Executive* 16, May 2002, pp. 132–148.

[16] Kelly, Marjorie, "Holy Grail Found," *Business Ethics* 19:4, Winter 2004, pp. 4–5.

[17] As of November 30, 2006.

[18] SocialFunds.com, October 31, 2006.

[19] Entine, Jon, "The Myth of Social Investing: Its Practice and Consequences for Corporate Social Performance Research," *Organization & Environment* 16, September 2003, p. 363.

manufacturing sector, including industrial material (0.47 of S&P weighting, according to), energy (0.34), and utility (0.17) stocks that have carried the market in recent years.

In defense of their avoidance of certain market sectors, social investing advocates have claimed that investment models suggest that it should take as few as two dozen stocks to ensure diversified performance over an extended period of time.[20] However, one recent controversial study comparing the risk-adjusted rate of return of portfolios consisting of socially invested mutual funds to one that tracks the market index over the period 1963–2001 found a yearly drag of 31 basis points.[21] Other studies have shown that the differences in risk-adjusted returns between screened portfolios and unscreened portfolios have been close to negligible. Social screens that result in the over-emphasis of particular sectors, such as technology stocks, and the under-representation of other stocks, such as natural resource and energy companies, could cause distortions in performance over shorter time periods that could persist for years. More than two decades of studies covering many time periods, when different industries and stocks were in vogue, are inconclusive about whether or how social screening impacts investment returns.[22] Future research may show that some aspects of social investing positively correlate with stock and financial performance. However, that conclusion is unwarranted based on current data.

Does Social Investing "Reform" Corporate Behavior

For most of its short history, social investing was focused not on changing corporate behavior but on buying goods and services that reflected the "green" ideology of its supporters. Borrowing the name of a book popular in the 1980s, and 90s issued periodically by the now defunct Council on Economic

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[20] See for example, Guerard Jr., J. B., "Is Socially Responsible Investing Too Costly?" *Pensions and Investments 25*, February 17, 1997; Bauer, R. and Otten, R. and Koadijk, K., "Ethical Mutual Performance and Investment Style," 2002 Moskowitz Award. www.socialinvest.org/Areas/Research/Moskowitz/moskowitz_versie.pdf; D'Antonio, Louis, Johnsen, Tommi and Hutton, R. Bruce, "Expanding Socially Screened Portfolios: An Attribution of Bond Performance," *Journal of Investing* 6, 1997, pp. 79–86.

[21] Geczy, Christopher, Stambaugh, Robert F. and Levin, David, "Investing in Socially Responsible Mutual Funds," Working Paper, May 2003.

[22] Waddock, S. A. and Smith, N., "Corporate Responsibility Audits: Doing Well by Doing Good," *Sloan Management Review* 41, Winter 2000, 75–83; Sauer, D. A., "The Impact of Social-Responsibility Screens on Investment Performance: Evidence from the Domini 400 Social Index and Domini Equity Mutual Fund," *Review of Financial Economics* 6, 1997, 137–149; Griffin, J. J. and Mahon, J. F., "The Corporate Social Performance and Corporate Financial Performance Debate: Twenty-Five Years of Incomparable Research," *Business & Society* 36, March 1997, pp. 5–31.

Priorities, which rated products according to social notions, baby boomers had a "Shopping for a Better World" mentality: buy Ben & Jerry's rainforest ice cream or Body Shop Amazon bath beads and get social justice thrown in for free. In other words, doing "good" required no sacrifice; just buy according to popular standards of liberal progressivism: rainforest chic.[23] According to cant, social investors can "invest for their own futures and a better world at the same time"[24]

However, SRI advocates have yet to persuasively prove the case that buying and selling stocks based on social criteria promotes "reform" or "social justice" or is in any way more ethical or "socially responsible" than mainstream investing. There are no agreed upon standards to determine which companies are more ethical and responsible. Each investor gets to decide for herself what is a "better world" and which companies are deemed ethical. Consequently, although popular liberal ideology dominates mainstream social investing, there are literally hundreds of funds and investment strategies with different ideological colorings and varying definitions of socially responsible and ethical corporate behavior. Social investing principles run the gamut from ultra liberal to right wing conservative, from pacifist to militarist, from Christian to Islamic.

While corporate social performance reflects a *substantive* definition of behavior that assumes that some choices are more ethical or socially responsible than others, social investing is burdened by a historical reliance on a client-centered *procedural* definition that requires only that the investor believes he is acting ethically.[25] According to the most vocal SRI industry advocates, clients can "invest for their own futures and a better world at the same time"[26] and social investing can "match your capital to the companies that best represent your moral and ethical values."[27] In other words, social investing is based on investor feelings – the "heart" according to social investor advocates who talk about aligning investments with one's beliefs – not explicitly on company behavior. Perception not changing corporate behavior remains the fundamental pillar supporting social investing.

As a result of this definitional ambiguity, social investing can often devolve into an exercise in tactics and liberal sentimentality, focusing on litmus screens

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[23] See Entine, Jon, "Rain-forest Chic: A Look at the Underside of Ethical Marketing," *Toronto Globe and Mail Report on Business Magazine*, October 1995, 12(4): 40+.

[24] Gravitz, Alicia, News Release: 2002 SRI Trends Report, page 1, accessed at www.socialinvest.org.

[25] Mackenzie, C., "Ethical Investment and the Challenge of Corporate Reform," PhD thesis, available from http://staff.bath.ac.uk/hssal/crm/, 1997.

[26] Gravitz, Alicia, News Release: 2002 SRI Trends Report available from www.socialinvest.org.

[27] Feigenbaum, Cliff, "Taking Stock: Investing with Your Head and Your Heart." *Vegetarian Times* 303, November 2002, 78+.

and pandering to perceptions, appealing to hot-button consumerist fads, and often ignoring questionable corporate behavior. Writing in the Winter 2004 issue of *Business Ethics*, Cheryl Smith, senior portfolio manager and research analyst at Trillium Asset Management in Boston, claimed that SRI funds had so far avoided the ethics scandal that have tainted other funds."[28] As it turns out, however, the social screens utilized by these funds did not protect their investors from ethical and financial scandals. Social funds held prominent stock positions in almost every corporation beset by scandal or accusations of financial and/or ethical impropriety, including Enron, WorldCom, HealthSouth, Global Crossing, The Body Shop, Odwalla, Adelphia, Quest, Tyco, Citigroup, Verizon, JP Morgan/Chase and AIG.[29]

SRI advocates are now trying to recast social investing as a reform movement, with corporate governance and transparency, as its central motif. "Where ten or 12 years ago, institutional investors were very careful to say, 'We pay attention to corporate governance but not social investing,' now there's no distinction," said Peter Kinder, president of KLD. "The trend is strongly toward incorporating the issues that social investors have been concerned about for 30 years into mainstream securities analysis." "Corporate irresponsibility did for social investing what Watergate did for politics," stated Cliff Feigenbaum, editor of *Green Money Journal*, a magazine that reports on the SRI industry.[30]

In a white paper on the goals of SRI, Steve Lydenberg, the Chief Investment Officer of Domini Social Investments, wrote that pension funds offer significant opportunities to expand mission-based investing. "Institutional investors should initiate ongoing dialogue among themselves on social and environmental issues, as they have begun to do on corporate governance issues," he notes. "As this occurs, the artificial distinction between corporate governance and corporate social responsibility will begin to blur."[31]

The reality, of course, is that in practice, there is a huge distinction between corporate governance practices and the version of corporate social responsibility promoted by the SRI movement. Until recently, the social investor's version of CSR was little more than impulse and ideology. It is easy for most people to agree on broad-brush social principles, such as supporting companies that do good things and avoid the bad guys. But moving from the abstract to the specific – what kind of corporate behavior or standards are deficient or

[28] Smith, Cheryl, "Surviving the Roller Coaster Ride," *Business Ethics* 19:4, Winter 2004, 17.

[29] Entine, Jon, "U.S. Pension Funds, Social Investing, and Fiduciary Irresponsibility," *Ethical Corporation*, January 2004.

[30] Blumenthal, Robyn Goldwyn, "Good Vibes: Socially responsible investing is gaining fans and clout," *Barron's Mutual Fund Quarterly Report*, July 7, 2003.

[31] Lydenberg, Steven, "Envisioning Socially Responsible Investing: A Model for 2006," Institutional Shareholder, available from http://www.institutionalshareowner.com/commentary.html?id=10

acceptable – is tremendously complicated and often contentiously debated. For CSR to be more than just a code word and empty symbol, it demands systems of accountability and transparency – clear criteria agreed upon by corporations, regulators, and the public that bring together the ideological left and right. In contrast, the SRI movement and some public pension funds that have adopted their investment philosophy serially target individual companies for perceived indiscretions without offering any comprehensive vision of corporate reform or responsibility standards.

Have Pension Funds Benefited from Social Investing?

Public pressure on public pension managers to incorporate some social factors, including using funds to target economically depressed areas, crept in during the late 1970s and accelerated in the 1980s. The earliest pension fund social investing initiatives were often cobbled together during regional crises with little appreciation for unintended consequences. For example:

- In the 1980s, the Alaska public employees and teacher retirement funds loaned $165 million, 35 percent of total assets, to make mortgages in Alaska. When oil prices fell in 1987, so did home prices. Forty percent of the loans became delinquent or resulted in foreclosures.
- In 1989, in what may well have been an election-year bailout of a failing firm, the State of Connecticut Trust Funds invested $25 million in Colt's Manufacturing Co. after a lobbying effort to save jobs; the company filed for bankruptcy three years later, endangering the trust funds' 47 percent stake.
- In the late 1980s, the Kansas Public Employees Retirement System (KPERS), then considered a model of activist social investing, invested $65 million in the Home Savings Association, an investment that became worthless when federal regulators seized the thrift. All told, KPERS wrote off upwards of $200 million in economically targeted investments.[32]

Olivia Mitchell of the University of Pennsylvania reviewed the performance of two hundred state and local pension plans during the period 1968 and 1986 and found "public pension plans earn[ed] rates of return substantially below those of other pooled funds and often below leading market indexes."[33] In a study of fifty state pension plans over the period 1985 to 1989, Roberta

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[32] Moore, Cassandra Crones, "Whose Pension Is It Anyway? Economically Targeted Investments and the Pension Funds," *Cato Policy Analysis* No. 236, September 1, 1995.

[33] Mitchell, Olivia S. and Ping-Lung Hsin. "Public Sector Pension Governance and Performance", In T*he Economics of Pensions: Principles, Policies, and International Experience* Ed. by S. Valdes-Prieto (Cambridge: Cambridge University Press, 1997), pp. 92–126.

Romano of Yale University concluded, "Public pension funds are subject to political pressures to tailor their investments to local needs, such as increasing state employment, and to engage in other socially desirable investing." She noted that investment dollars were directed not just toward "social investing" but also toward companies with lobbying clout.[34]

Because of poor returns in these early experiments in economically targeted investments, most states and municipalities steered clear of social investing. That hesitancy eroded during the 1990s, as the political taboos receded and the coffers at some of the largest pension funds swelled. Elected officials in New York, Connecticut, Minnesota, and most notably California began to dabble in asset allocation decisions focusing in part on a growing list of social concerns.

California's Public Employees Retirement System (CalPERS) and State Teachers Retirement System (CalSTRS), the country's most politically influential public pension system, together hold more than $300 billion in assets. That's an enormous aggregation of shareholder voting power, a fact that has not been lost on ambitious politicians. Beginning in the mid-1990s, CalPERS and CalSTRS flexed their financial muscles by demanding corporate governance reform by publicly excoriating companies that they deemed to be poorly managed. Over the years, CalPERS has increased its scrutiny of companies and corporate directors. After the passage of Sarbanes-Oxley in 2004, CalPERS began automatically withholding proxy votes from all members of audit committees that hired outside auditors to perform non-audit services. It ended up blanketing public companies whose stocks it held with votes against directors, including Berkshire Hathaway Inc. Chairman Warren Buffet. It's blunt approach came under intense criticism, forcing CalPERS in March 2005 to modify its stance, focusing on audit firms instead of directors, except in cases in which "egregious" conflicts of interest have occurred.[35]

By the late 1990s, the California pension fund twins had also begun to focus more directly on social issues, setting aside billions of dollars for favored causes. For example, the two pension systems combined to commit $7 billion in 1999 to a program it called Smart Investments to support "environmentally responsible" growth patterns and invest in struggling communities. However, as in the cases of Alaska and Kansas in the 1980s, there were no accountability provisions to measure the impact of the venture, let alone to determine its financial consequences.

In 1999, California State Treasurer Philip Angelides helped persuade officials at CalPERS and CalSTRS, on whose boards he sat, to sell $800 million in tobacco shares. As Angelides said at the time, "I feel strongly that we wouldn't

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[34] Romano, Roberta, "Public Pension Fund Activism in Corporate Governance Reconsidered," *Columbia Law Review* 93, 1993, pp. 795–853.

[35] Lifsher, Marc, "CalPERS Voting Criteria Altered," *Los Angeles Times*, March 15, 2005, C2.

be living up to our fiduciary responsibility if we didn't look at these broader social issue. I think shareholders need to start stepping up and asserting their rights as owners of corporations. And this includes states and their pension funds."[36] Since California sold the tobacco shares, the AMEX Tobacco Index has outperformed the S&P 500 by more than 250 percent and the NASDAQ by more than 500 percent. That decision alone has cost California pensioners more than a billion dollars.

Despite that huge financial setback, California and numerous other state and municipal authorities began accelerating their social investing activities in recent years, empowered by a 1998 Labor Department letter that made clear that socially screened funds could be included in qualified retirement plans. The Department of Labor has also said that pension plan administrators have a fiduciary duty to vote their proxy in shareholder elections, and union pension funds have in fact been in the vanguard of recent activism by shareholders. For example, union funds frequently support shareholder initiatives to cap executive compensation and to withhold votes from certain directors, and unions were among the most articulate proponents of the "shareholder access" rule that was considered by the Securities and Exchange Commission under Chairman William Donaldson. Some public pension funds are using their power as shareholders to further organizing objectives or political goals, rather than to maximize the value of plan assets.

Public funds which not unreasonably expect purity from corporate officers and directors have turned out not to be so pure themselves, and often do not have the kinds of stringent standards and policing measures which are now expected – though not always found – in the more highly regulated private sector. The foray into social investing by CalPERS and CalSTRS, once considered leading corporate governance bulldogs, has highlighted the conflicts of interest that beset the management of many funds now using social investing. CalPERS committed more than $760 million in 2001 and 2002 to two funds created by Los Angeles billionaire Ronald Burkle, who, with his wife, contributed to Angelides' run for state treasurer. Eleven of the 13 CalPERS board members have union ties, including Angelides, who is actively courting labor endorsements for his announced 2006 gubernatorial run. CalPERS president Sean Harrigan, who is also executive director the United Food and Commercial Workers Union, was ousted from the board in December 2004, in part because of his attempts to involve CalPERS into a labor dispute between Safeway and the UFCWU.[37]

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[36] Bayon, Ricardo, "California Leading," *Environmental Finance*, September 1, 2002, available from http://www.newamericafoundation.org/index.cfm?pg=article&DocID=963

[37] Parloff, Roger, "Pension Politics," *Fortune* 150, December 27, 2004, pp. 27–32.

New York State Comptroller Alan Hevesi, another social investing advocate, intervened during the 2004 presidential election when Sinclair Broadcast Group decided to air a controversial documentary about John Kerry's post-Vietnam war activities. Hevesi, a Democrat and sole trustee of the state's Common Retirement Fund, which owned about 250,000 shares of Sinclair stock, sent the company a threatening letter saying the airing of the broadcast could hurt "shareholder value." The criticism, subsequently joined by numerous apolitical independent money managers, sent Sinclair's stock plunging 15 percent.[38]

In Ohio, in an attempt to create jobs, activists in the state legislature backed by large labor unions are trying to force the Ohio State Teachers Retirement System to invest not less than 70 percent of equity and fixed-income trades with approved Ohio-based brokers and no less than an additional 10 percent with minority business firms. Dubbed "Buy Ohio," the bill has provoked critical editorials from most major Ohio newspaper concerned about the circumvention of traditional fiduciary standards. Even some public workers, who were being counted on to back the measure, have come out against the bill, claiming there is not enough investing expertise among brokers in the state to responsibly handle multi-billion dollar portfolios, and estimating potential losses at $180 million.[39]

Union supporters are using their pension fund connections to marshal opposition to privatizing Social Security. Gerald Shea, a top lobbyist for the AFL-CIO, has warned some of the country's largest brokerage firms including State Street, J.P. Morgan Chase & Co., Morgan Stanley, Merrill Lynch & Co., Barclay Global Investors N.A., T. Rowe Price Group Inc., Wachovia, and Charles Schwab against supporting the Bush Administration initiative. According to Shea, organized labor, whose members have an estimated $400 billion invested in public employee pension funds, has "no intention of letting any of these companies get away with [supporting the President's proposal] while they manage our workers funds," Shea commented.[40] Echoing the union's stance, three trustees representing the New York City Employee's Retirement System sent a letter to a half-dozen investment banking companies demanding a review of their position on Social Security reform.[41]

The attacks led the Financial Services Forum, an umbrella organization of 21 chairmen of large financial institutions for executives of large financial services companies, to pull out of Compass, a business group that has been

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[38] Gegax, Trent T., "Stolen Honor: Democrats Fight Back and Win," *Newsweek*, October 20, 2004, available from http://www.msnbc.msn.com/id/6293163/site/newsweek

[39] See "OP&F Unites with Ohio Retirement Systems in Concern Over House Bill 227," News Release, November 19, 2003, available from http://www.opf.org/news/default.asp?id=11192003

[40] Newmyer, Tory, "Social Security Critics Slow to Coalesce," *Roll Call*, January 31, 2005.

[41] "Pension Fund Blackmail," *Wall Street Journal*, March 31, 2005, A10.

supporting the president's plan. Previously Waddell & Reed Financial Inc. and Edward D. Jones & Co. withdrew from the FSF over this issue.[42]

While the SRI movement was launched by and is still mostly encouraged by social liberals, true believers across the political spectrum and those determined to reward favored constituencies have actively promoted social investing. Consider the ongoing debate over whether to buy stock in Walt Disney, which has long been a favorite equity holding in many liberal SRI portfolios. In 1998, the Texas legislature prohibited state agencies from investing in companies that own ten percent or more of a business that records or produces music glamorizing or advocating violent criminal acts, illegal drug use or perverse activities.

The conservative American Family Association of Texas immediately targeted the state's $27.5 million holdings in Disney. "We believe investing in a company like this is bad public policy," said Wyatt Roberts, executive director of the Family Association. "I don't think that the citizens of Texas like the idea of subsidizing the destruction of their own children through the Disney Corporation." "I think we should be setting a good example for the children of Texas," added Dr. Richard Neill, a state board member from Fort Worth.[43]

Although Disney had already netted the fund a healthy 35 percent return when the controversy ensued, some board members were more animated by their personal ideological convictions than their fiduciary responsibility to pensioners.

Conclusion

Public pension funds will remain enormously important and growing factors in the financial markets for the foreseeable future. Certainly, as part of their fiduciary mandate to maximize investment returns for their beneficiaries, pension-fund trustees have a right and duty to lobby for changes in corporate behavior that could result in better returns for their pension holders. But judging by the words and actions of some pension funds activists, "shareholder value" has become a fig leaf to justify a range of actions that may put at risk, directly or indirectly, the retirement holdings of its members, limit potentially profitable investments, and muzzle debate on government reforms.

While social investments including economically targeted investments rightfully fall within the bailiwick of legislatures, whose representatives are subject to the vote of constituents, they've periodically proved disastrous for public

[42] Cocco, Marie, "Dirty Battle in the Social Security War," *Newsday*, March 29, 2005.

[43] Robbins, Mary Alice, "Group Wants Texas Schools to Dump Disney," *Morris News Service*, July 2, 1997.

pension funds, which don't submit such decisions to the vote of their members. Pension funds are being dragged into treacherous waters where political and moral views threaten clear financial mandates. Politicians often invest in areas where they lack expertise, especially when their proposals involve contentiously debated issues such as the causes of global warming or the cost and benefits of genetically-altered food.

Should we boycott tobacco companies, natural resource firms that do not embrace radical global warming initiatives, or firms that utilize genetic engineering in agriculture even though a boycott would have no discernible impact on the operations or profits of these companies, but risks devastating the returns of pensioners who often have little say in what's being done in their name?

It's even questionable whether social investing, by pension funds or the general public, serves to promote the causes its advocates claim to embrace, let alone "do good". By implicitly encouraging the belief that the intentions of a business can be judged distinct from its economic impact, social investing often promotes corporate behavior that is neither socially progressive nor ethical, and may certainly result in adverse consequences to stakeholders, including pensioners. In many instances, it amounts to gambling with other people's money in support of ideological vanity.

A few politicians have begun speaking out against risking pension funds on political causes. "I don't think that we should be using the city's investments policies … to advance social goals, no matter how admirable those goals are and no matter how much I believe in it," said New York Mayor Bloomberg, who is a trustee of the fire and police pension funds.[44]

But Bloomberg's stance may be quixotic. With politicians and union officials dominating the decision-making process investment decisions in public employee and teacher retirement systems, the politicization of the pension fund system will likely grow in the years to come. To some extent, the public funds have been the beneficiaries of benign neglect by the business media or academic business ethicists, which for the most part have left the large funds relatively unscrutinized. Considering their size, wealth and influence of the public funds, this lack of scrutiny will not and should not continue much longer.

[44] Hafetz, David, "Use of Pension Funds Faulted by Some: Critics Fear Pension Activism," *New York Sun*, July 22, 2004.

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