JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

I. MANUSCRIPTS

C. Published Journal Articles

1. "Implication of Vested Benefits in Private Pension Plans: Comment", Journal of Risk and Insurance, Vol. XXXIV, March, 1967

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IMPLICATIONS OF VESTED BENEFITS IN PRIVATE PENSION PLANS: COMMENT

James A. Graaskamp*

At the risk of creating a column of "amplification and clarification" in the befuddling manner of the *New Yorker Magazine*, I would like to advance the thoughts of Professor Joseph J. Melone regarding provisions for vesting within a variety of pension contract objectives, to specific points for negotiation by the parties at interest. This comment is in essential agreement with Professor Melone on all the details of his article[1] except the premise that "the problem to which proponents of vested benefits in pension plans address themselves is well recognized."

The gist of this comment is that the problem of vesting is not often recognized as fundamentally a question of risk management, of identification, measurement, incidence, and control of the non-continuity risk of loss to benefits under private pension programs, a risk which should be treated as the normal, operational expectancy for a majority of private pension agreements.

The essential difference between OASDI and the private effort to provide pensions is the question of benefit continuity if the plan or individual employment is terminated, voluntarily or not. Aside from the poor soul without dependents who dies prematurely only minutes before his Social Security retirement payments should begin, OASDI is virtually a riskless allocation of wages in lieu of cash, regardless of where the participant may work, when, for how long, or why he was discharged or switched from one job to another.

On the other hand, the private plan can be characterized in this regard by Professor Melone's statement that "In the absence of vested benefits, job separations for reasons other than retirement, death or disability, preclude many workers from meeting the age and service requirements for entitlement to retirement benefits under the plan."

If OASDI is virtually riskless, the essence of the vesting problem for private pension efforts is deciding to what degree the pension participant should be expected to bear the very real risks of termination, voluntary or involuntary, and to what degree vesting of nonassumed benefit losses can be made meaningful with funds within the financial capacities of the employer. Since vesting problems of voluntary termination are a function of loyalty, incentives and other considerations, concern in these lines is for the greater potential inequities of involuntary termination.

Vesting provisions can be drafted with relative ease (1) if the bargaining agent for the participant can find a consensus within his own group as to how terminal benefits and losses for each type of welfare program will fall on each recognizable age and service sub-group among

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[1] Joseph J. Melone, "Implications of Vested Benefits in Private Pension Plans," *Journal of Risk and Insurance*, Vol. XXXII, No. 4 (December, 1965), pp. 559-69.

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the participants, and, (2) if the bargaining agent for the employer can find agreement on definitions of what is a gratuity and what is deferred compensation, so far as terminal shock losses based on these definitions would affect management financial plans, creditor security, and investor dividend and capital equities.

By convenient coincidence, my dissertation, *Pension Termination Due to Business Failure, Liquidation, or Migration,*[2] bears exactly on the point of involuntary termination, and therefore, inescapably, on vesting as primarily a risk management problem in its conceptual and analytical treatment. Perhaps the title of this treatise was deceptive for it proved impossible to separate the problems of equity in event of total or partial termination of a pension plan from those of involuntary termination of employment for a single individual participant in the plan.

In the general recognition of vesting as "a puzzlement" within the untidy and implicit legal and economic compromises of most negotiated pension contracts, one is reminded of Galbraith's comment on the nature of a vested interest:

> The notion of a vested interest has an engaging flexibility in our social usage. In ordinary intercourse it is an improper advantage enjoyed by a political minority to which the speaker does not himself belong. When the speaker himself enjoys it, it ceases to be a vested interest and becomes a hard-won reward. When a vested interest is enjoyed not by a minority but by a majority, it is a human right.[3]

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(1) The present legal system provide
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be shown to exist.

(2) The pension expectation has its origin in a private contract for private purposes and is concerned with a contingent future interest in property.

(3) A pension expectation becomes a legal right only when an individual has fulfilled conditions precedent to a specific ownership interest.

(4) The substance of this right depends on the certainty of periodic retirement payments from an employer or from segregated assets or funds.

(5) A pension plan with a funding formula has a basic premise that over a period of time an employer can accumulate from income and segregate sufficient wealth to honor the employee's expectation or right.

(6) During the process of accumulation these segregated funds are in a legal limbo in terms of who specifically enjoys the right of ultimate title.

(7) While the pension sponsor completes the required funding process to

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[2] The dissertation was completed in August, 1964. It was based on data obtained with the support of the Ford Foundation study of retirement plans from the viewpoint of the older worker, conducted by the faculty of the School of Commerce in the University of Wisconsin. The research program thus sponsored encompassed a number of scholastic disciplines and subjects, and this particular study was a part of the area on "Safeguarding of Pension Comitments to the Older Worker."

[3] John Kenneth Galbraith, *The Affluent Society* (Boston: Houghton Mifflin Company, 1958), p. 181.

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create wealth, the individual participant must complete the required service process to acquire property interests, both of which require time, perhaps forty years or more.

(8) The passage of time exposes both parties to a wide number of exogenous loss-causing variables which cannot be anticipated or controlled, thus undermining the latent effectiveness of pension expectancies.

(9) The uncertainties for the employer and employee combine to a probability that neither shall see successful execution of the plan in the long run, and therefore the original plan must be designed to meet premature termination of the process by one or the other of the parties, or both, as the normal expectancy.

(10) It follows that negotiation of the pension plan should be in part determination of the distribution of the uncertainties of pension realization between the employer and various groups of employees as defined by age and service. If the parties, in serving their own objectives, can agree realistically as to which risks of employment and business profitability are to be borne by the employer and by the employee, and if the employees can decide who among them shall have a claim on pension resources as opposed to other welfare benefits—then vesting, funding, and distribution of "unowned pension fund capital" are easily incorporated into terminal provisions which apply equally to termination of the plan in whole or in part or to individual employment termination.

In our opinion, behind the great debate of private pension plan issues—gratuity vs. deferred wage, vesting vs. economic feasibility, actuarial soundness through full funding vs. corporate financial viability, and all the many corollary issues—there is one central theme: To what degree shall each party at interest in a pension plan bear the financial risks of dynamic economic change in business and employment, as it affects pension plan expectancies?

Resolution of the quandary thus posed must be founded on certain economic and ethical premises. In part, the American economic system is predicated on mobility of capital and labor, on a speedy exit from the economic scene for those unable to prosper as well as on freedom of entry into any field for those seizing opportunities. A predilection for material and human conservation demands a system by which enterprises can be newly cast or abruptly scrapped while conserving each element of the business alloy of human life commitments, social capital investment, and natural resource allocation.

The personnel of business must be prepared, financially and mentally, for a constant progression of regroupings within and among various businesses as the pace of technological and market changes accelerates. Concurrently the individual employee should be insulated to a degree from some of the financial consequences of regroupings as required by a viable economy.

Such a value judgment does not mean that the individual need not share responsibility for his own economic security or that full responsibility should rest with the government, a philosophy which has found expression in various aspects of current welfare economics. Instead, it should be remembered that pension plans evolve as part of the incentive system. Implicit in these comments (and those of Professor Melone, I believe) is that the private pension should continue to relate to loyalty, services rendered, and the vested interest of the employee in the continued prosperity and productivity of his employer, at least within equitable limits.

With such an underlying ethic and with a momentary slighting of problems of conflicting terminal interest among subgroups of pension bargaining interests, a pivotal key to terminal equity, we believe, turns on a distinction between pension credits given for service prior to the existence of the pension plan and pension credits earned following initiation of the pension plan.

Former service credits would seem so clearly a gratuity that the amortization of this liability over twenty years or more would not seem an unjust exposure of the employee interest to the vicissitudes of business earnings. Prior to the plan he had no reason to anticipate these benefits in making his financial plans nor did the employer have any responsibility for providing these benefits from his financial resources. Equitably, the employee should bear the risk of non-fulfillment of the funding objective if the employer is willing to bear the cost of funding these benefits should future earnings permit.

An established pension plan with a given work force, on the other hand, does provide a foreseeable business cost for currently earned pension credits, a cost to be charged to current production. Where the plan is negotiated, noncontributory, and a tool of personnel policy, an earned pension benefit is logically an element of wage compensation and thus, in its most elementary form, a benefit to be funded and vested.

There are several social considerations which can modify the currently earned, currently vested approach to pension benefits. First, society has always seen fit to provide various devices to limit the liability of the entrepreneur in order to encourage him to explore economic opportunity more aggressively and to make more economic enterprises feasible. At the same time, the private pension is recognized as a tool of personnel management, a form of motivation designed to stabilize the work force and standardize company policy in regard to its long term and older employees. By making any pension benefits contingent on some years of service and continued loyalty, the business objectives of the plan can be advanced while delimiting cost within employer capacities.

Society also would favor recognition of the immediate needs of the retired or about-to-be-retired worker. Can there be any reason why these employees after retirement must continue to bear any exposure to the loss of pension income because of change in the economic fortunes of their past employers? This risk might properly be that both the employer and the active employee, who could share it by funding the past service liability, upon retirement, from additional payments by the employer and from savings due to the absence of earned benefits for the youngest and lowest seniority workers in the employee work force, at least for three to five years of initial service.

Resolution of the policy question of risk might then be possible by distributing the risks implicit in the contingencies of a pension expectation introduced by the mortality of economic enterprise as follows:

(1) Immediate retirement benefits: fully funded by combined sacrifice of employer and active employee.

(2) Vested earned service pension liability: an immediate cost of the employer.

(3) Past service pension liability: a cost of the employer contingent on continued operations at risk of the employee.

Immediate retirement benefits would receive clear support from the law of deferred compensation; earned benefits would clearly vest only after satisfaction of qualifying contingencies, following the law of contingent contracts; while past service claims would be identified as gratuities, and would be the only pension obligation which the employer could escape without further responsibility.

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from service following plan initiation but prior to qualification for vesting:

(1) If recognized, these pension credits could be included in the past service liability reserve, shifting the risk of continuity for unvested benefits to the employee so long as service requirements for vesting were not too long.

(2) On the other hand, if service prior to vesting were held to only a few years, no benefits need accrue, simplifying termination problems for the cyclical employer while providing funding economies which might offset immediate funding costs for retirement commitments. It probably could be shown that involuntary employment termination within three to five years of initial hiring would be better served through a separate supplemental unemployment severance pay program.[4]

The ranking of these priorities and benefits would permit an automatic and continual reallocation of available funds according to an accounting arrangement parallel to spillover trusts. On any given date actual funds in hand would first be related to existing commitments to retired employees; any balance of funds and promissory notes from the employer would then be allocated to earned deferred benefits, and to the degree there was any balance of assets at liquidating values remaining, some part of the non-vested past service benefits would be funded.

With retirements, deferred benefits for past service would be transferred to first priority, and at any point that the total available assets and commitments of the pension sponsor did not total the termination values of retirement and earned deferred benefits, the sponsor would be required to make up the difference.

The relative weight given age over service in the event of termination could be negotiated by deciding how early retirement ages, deferred retirement, and retroactive inclusion in the plan would transfer unearned past credits to vested retirement credits. At the same time, possible shortages of funds would first affect the capacity to pay past service benefits, then vested earned benefits, with an actuarial proration.

On any given day, a single employee, half the work force, or all the participants would know the degree to which their expectations had been funded, should termination occur. Their interest, frozen upon termination, would be the equivalent values in cash or deferred insured benefits to which the terminated employee would be entitled. Termination dates could be defined by the labor contract or by common law in relation to the last day worked, expiration of layoff, seniority retention, or other factors.

Such a formula is exactly what is now negotiated once a plant is shut down or a significant work force released, and it represents the real distribution of funds far better than the present actuarial reserve formulas which define liabilities as though the plan will be continued indefinitely to pay both vested and unvested, earned and unearned benefits regardless of special terminal priorities established elsewhere in the plan.

Much like existential concepts of being as a process of becoming until death places a final limit on development, pension expectations might be thought of as contract rights in the process of becoming court-recognized quantities in the nature of property. The final test of the substance into which these rights have been transmuted by the passage of events would be at the point in time where the pension plan or continued individual participation was brought to a close.

A finite measure of what a pension is to become is the reserve which represents

[4] Experience shows that involuntary termination awards from pension funds are damaging to the pension interests of those remaining with the firm and confuses pension costs with employer obligations for supplemental unemployment responsibilities.

the allocation of claims against assets, and each type of future pension claim should be represented by a distinct and individual present value reserve, so that the degree of funding for each type of claim would be readily apparent upon reading of the regular financial statement.

Since the plan calls for certain contingencies requiring immediate funding commitments on the part of the sponsor, it is necessary to provide a device which replaces the option of the sponsor from a question *if* it should fund earned and vested benefits to *when* it should actually transfer the money. For lack of a better term, a surplus note, subordinated to all company debt, could be designed.

Today a patchwork of contract priorities or topical termination improvisations decide how inadequate funds will be prorated among retired or deferred pension benficiaries. Appropriate legal theories can seldom be twisted to fit the equity position of the disappointed participants, the actuarial reserves reflect the benefit formulas of the long-term program, not abortive termination, and there is no equity among groups classified by age, service, employment status, discharged or continued on the payroll by the failing firm, left behind or relocated by the migrant employer. Without a semblance of equity in contract provisions for termination in varying degrees, it is difficult to find equity in the courts.

Those who have studied the failure of private pensions to solve the social and legal implications of continuity should be able to flesh out the bare bones of the proposals above with positive applications to resolution of actuarial solvency dilemmas, of equity conflicts between discharged employees and retained employees in regard to pension fund assets, and of concealment of the inadequacy of initial pension program provisions for funding or termination. Moreover it makes explicit the value decisions which are implicit in special terminal amendments to existing plans, which have provided many opportunities in the past for employers and labor representatives to use terminal distribution negotiations as a cloak for non-pension objectives. Certainly the dichotomy of reserves for each element of the pension benfit formula would destroy the false security of gross funding ratios, undermine the optimistic economic myopia of those responsible for the stretchout of pension funding, and check the tendency toward benefit formulas far in excess of capacity to fund these benefits.

All these advantages are only derivative of the more significant fact that recognition and design for premature termination of pension plan or participant as the *normal expectancy* makes possible a single, equitable pattern of allocation of inadequate resources to any scale of involuntary termination. If terminal rights at any point in time are the same for any type of involuntary termination, then it follows that definition and allocation of the risks of pension benefit continuity, consistent with the objectives of each party as outlined by Professor Melone, can be the basis for "some reasonable measure of vesting" within the present pension tax framework.

This goal has been sought most recently by the President's Committee on Corporate Pension Funds and Other Private Retirement and Welfare Programs.[5] Moreover, a definition of vesting, backed with specific documents of employer funding commitments in the form of surplus notes, could establish an insurable value which might be appropriate as the interest covered by, and the premium basis for, the proposed Federal Re-Insurance of Private Pension Plans.[6]

[5] "Public Policy and Private Pension Programs—A Report to the President on Private Employee Retirement Plans by President's Committee on Corporate Pension Funds and Other Private Retirement and Welfare Programs (Washington, D.C.: U.S. Government Printing Office, 1965), pp. 42 et seq.

[6] "Federal Re-Insurance of Private Pension Plans Act," Senate Bill No. 1575 and House Bill No. 6944 of the first session of the Eighty-ninth Congress.