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WORKER OWNERSHIP THROUGH 401(K) RETIREMENT PLANS: ENRON'S CAUTIONARY TALE

DAVID MILLON†

INTRODUCTION

Peter Drucker coined the term “pension fund socialism” in 1976 to draw attention to the increasingly large percentage of United States equity capital owned by pension funds and other large institutional investors.¹ He was concerned with the implications of this phenomenon for corporate governance. He believed that these changes in the distribution of share ownership meant the final erosion of managerial accountability. Pension fund managers, focused solely on investment return, had no interest in monitoring the performance of corporate management. This development, he wrote, “makes final the divorce of *traditional* ‘ownership’ from ‘control.’”²

Today, of course, pension funds and other large institutions own an even larger portion of the stock of our nation’s largest corporations—over half of outstanding shares.³ For some well-

† Associate Dean for Academic Affairs and J.B. Stombock Professor of Law, Washington and Lee University. The author gratefully acknowledges the comments and suggestions of Maureen Cavanaugh and Susan Stabile and expresses his appreciation for the opportunity to have participated in the Symposium: *Enron and Its Aftermath*, St. John’s University School of Law, Jamaica, New York (Sept. 20, 2002).

¹ PETER F. DRUCKER, *THE UNSEEN REVOLUTION: HOW PENSION FUND SOCIALISM CAME TO AMERICA* 47 (1976) [hereinafter *THE UNSEEN REVOLUTION*]. This work was reissued with a new introduction and epilogue in 1995. See PETER F. DRUCKER, *THE PENSION FUND REVOLUTION* (1996).

² *PENSION FUND REVOLUTION*, *supra* note 1, at 82 (italics in original). The reference to separation between ownership and control echoes Berle and Means’ highly influential analysis of the governance implications of broadly dispersed share ownership in public corporations. See generally ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

³ See ROBERT W. HAMILTON, *CASES AND MATERIALS ON CORPORATIONS* 624 (7th ed. 2001) (noting that, as of 1992, institutions owned over half of the outstanding shares of New York Stock Exchange listed companies).

known companies, aggregate institutional shareholdings can reach eighty or even ninety percent of outstanding shares.⁴ Drucker's governance concerns are thus amplified. One result has been a flurry of academic debate over the possibility and desirability of "institutional investor activism" as a mechanism for enhancing management accountability to shareholders.⁵

Drucker used the term "socialism" to highlight the fact that large-scale stock ownership by pension funds has effectively turned workers into owners of America's largest corporations.⁶ Both private pension funds of large corporations and state-run pension systems manage trillions of dollars for the benefit of private and public-sector employees. The assets of these plans are heavily invested in publicly traded stock, so their beneficiaries can claim to own, at least indirectly, a large percentage of a significant sector of the means of production in this country.

Drucker's primary concern focused on the implications of this phenomenon for the accountability of corporate management to investors; consequently, he did not elaborate on the political implications of his use of the term "socialism." In this Article, I wish to point out a different dimension of the pension fund socialism idea. The proliferation of employer-sponsored pension plans in the private sector has transformed workers into owners of stock in their own companies. This is because the increasingly dominant form of pension plan—the so-called 401(k) plan—allows, and in many cases encourages, workers to invest their retirement savings in company stock.⁷

Advocates of worker ownership have long touted its

⁴ See *id.* at 625.

⁵ See, e.g., Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 530–64 (1990) (discussing legal obstacles to institutional shareholder activism). See generally Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993) (questioning possibilities for significant institutional involvement in corporate governance).

⁶ See THE UNSEEN REVOLUTION, *supra* note 1, at 2 (“[A]side from farming, a larger sector of the American economy is owned today by the American worker through his investment agent, the pension fund . . . than Castro’s Cuba has actually nationalized, or than had been nationalized in Hungary or Poland at the height of Stalinism.”).

⁷ For yet another meaning of the term “pension fund socialism,” see William H. Simon, *The Prospects of Pension Fund Socialism*, 14 BERKELEY J. EMP. & LAB. L. 251, 254–59 (1993) (using term to refer to investment of pension fund assets to promote socially responsible corporate activity).

superiority to investor ownership as a system for the organization of production. They continue to speak from both ends of the political spectrum. Enron illustrates the serious risks to employees of excessive 401(k) investment in company stock. The Enron disaster has led to proposals to strictly limit, or even forbid altogether, worker investment in their own corporation's shares. Before endorsing those proposals, however, I suggest it may be useful to review the principal arguments that have been advanced in favor of worker ownership. Because 401(k) pension plans are increasingly common and, as a practical matter, the most effective method for promotion of worker ownership, reform proposals that would curtail or eliminate this possibility should be evaluated in light of the potential benefits of worker ownership. After a review of ways in which 401(k) pension plans can facilitate workers' ownership of their own corporations, this Article discusses pension disasters at Enron and other companies and then reviews the principal arguments in favor of worker ownership. The Article concludes that none of these arguments is weighty enough to overcome Enron's lesson.

I. WORKER OWNERSHIP THROUGH 401(K) PLANS

A. *The Current Pension Landscape*

Under current law, there is a basic distinction between two fundamentally different kinds of pension plans. These are the so-called "defined-benefit" plans on the one hand and the "defined-contribution" plans on the other.

Defined-benefit plans are funded by the employer and commit the employer to pay the employee a defined pension benefit upon retirement.⁸ The employer determines the amount of its future pension obligations and sets aside the funds needed to meet those obligations. A qualified professional decides how these assets should be invested so as to generate the necessary returns.

In contrast, defined-contribution plans rely on contributions from employees.⁹ Employees contribute their own money—often

⁸ See 29 U.S.C. § 1002(35) (2001) (defining "defined benefit plan"). Defined-benefit and defined-contribution pension plans are regulated primarily through the Employment Retirement Income Security Act of 1974 (ERISA).

⁹ See 29 U.S.C. § 1002(34) (2001) (defining "defined contribution plan").

supplemented by a matching contribution from the employer—to a pension trust. Employee and employer contributions are then allocated to employees' individual accounts. In most defined-contribution plans, the employees decide how their contributions should be invested. They may also be able to make similar choices with regard to the employer's match.

In recent years, there has been a clear trend toward establishing defined-contribution plans and away from creation of defined-benefit plans.¹⁰ Defined-contribution plans now dominate the pension landscape. They account for over eighty percent of all pension plans and cover over sixty percent of plan participants.¹¹ Some companies maintain both defined-benefit and defined-contribution plans (including Enron), but for increasing numbers of employees, defined-contribution plans are either their sole or primary source of retirement security.

This development is important because defined-benefit and defined-contribution plans differ in how they allocate investment risk. Under a defined-benefit plan, the employer obligates itself to a defined payout. If it sets aside insufficient funds or if those funds are invested in securities that do not perform as well as expected, the employer may find itself unable to meet its obligations to its retirees. The employer therefore bears the risk of its own funding and investment decisions.¹² In contrast, the employee's pension benefit under a defined-contribution plan depends on the value created by his or her own savings and investment choices. Bad decisions can yield inadequate retirement benefits.

The 401(k) plan is the most common type of defined-contribution pension plan. It is named for the Internal Revenue Code provision that allows employees to defer income taxation on contributions to qualified pension plans.¹³ As the most common

¹⁰ See *Retirement Security and Defined Contribution Pension Plans: The Role of Company Stock in 401(k) Plans: Hearing Before the Senate Fin. Comm.*, 107th Cong. 2 (2002) (statement of Jack L. VanDerhei) (commenting that, in the twenty years after 1978, the percentage of active participants decreased by approximately one-half).

¹¹ See Susan J. Stabile, *The Behavior of Defined Contribution Plan Participants*, 77 N.Y.U. L. REV. 71, 74 (2002) (noting that such high percentages amount to the participation of roughly forty million employees nationwide).

¹² Under certain circumstances, the Pension Benefit Guarantee Corporation, established by ERISA, guarantees payment of pension benefits to retirees whose employer's plan is under-funded. See 29 U.S.C. § 1305 (2001).

¹³ See 26 U.S.C. § 401(k) (2001).

form of defined-contribution plan, the 401(k) is therefore the primary vehicle for retirement security in this country. Approximately forty million Americans participate in such plans.¹⁴

B. *Company Stock in Defined-Contribution Plans*

The typical defined-contribution plan presents the employee with a menu of diversified mutual fund and other investment options selected by the employer. These options can include the employer's own stock, an option that is more likely in larger corporations than in smaller ones.¹⁵ The employer's matching contribution can also take the form of company stock. Under some plans (including Enron's), this is the only option. When employers contribute company stock, typically the employee will be forbidden from selling those shares and reinvesting the proceeds until he or she reaches a defined age, often fifty, fifty-five, or sixty. At Enron, the age was fifty.¹⁶

ERISA prohibits defined-benefit plans from holding more than ten percent of plan assets in company stock.¹⁷ No such statutory limits apply to defined-contribution plans, either in the aggregate or as to individual employee accounts. For all plans offering company stock as an option, the average amount of plan assets allocated to that investment option is nearly forty-two percent.¹⁸ At a number of companies, however, the percentage of 401(k) assets invested in company stock is even higher. At Enron, it was nearly two-thirds.¹⁹ At a number of other well-known companies, the percentage is quite a bit higher. For

¹⁴ Stabile, *supra* note 11, at 74.

¹⁵ See Jack L. VanDerhei, *Company Stock in 401(k) Plans: Results of a Survey of ISCEBS Members*, at 5 (Employee Benefit Research Institute Special Report) (Jan. 31, 2002) (reporting that 49% of large plans compared to 36% of small plans mandate employer contributions be invested in the company's own stock), at <http://www.ebri.org/pdfs/iscebs.pdf>.

¹⁶ See ENRON CORP. SAVINGS PLAN, at V-1.

¹⁷ See 29 U.S.C. § 1107(a)(2) (2001). Specifically, the statute requires a plan not to "acquire any qualifying employer security or qualifying employer real property" if doing so would cause "the aggregate fair market value of employer [assets] held by the plan [to exceed] 10 percent of the fair market value of the assets of the plan."

¹⁸ Shlomo Benartzi & Richard H. Thaler, *Naive Diversification Strategies in Defined Contribution Savings Plans*, 91 AM. ECON. REV. 79, 90 (2001).

¹⁹ Patrick J. Purcell, *The Enron Bankruptcy and Employer Stock in Retirement Plans*, at 3 (CRS Report for Congress) (Jan. 22, 2002), at <http://www.house.gov/boozman/issues/crsrsenron.pdf>.

example, at Proctor & Gamble, the figure is 91.5%.²⁰ Other examples include Abbott Laboratories, 80%; Pfizer, 74.8%; Anheuser-Busch and Coca-Cola, each around 82%; and General Electric, 77%.²¹

These being aggregate numbers, at these companies (and at many others), an individual employee's holding of company stock as a percentage of his or her retirement portfolio could be even higher. Clearly, many employees are not following prudent diversification strategies, choosing instead to put all or most of their pension eggs in a single basket. Apparently, low wage workers are especially likely to over-invest in company stock.²²

In some cases, over-investment may simply result from management's encouragement. At Enron, for example, in August 2001, CEO Ken Lay told employees, "Now is the time to buy Enron shares"²³ and, in September, he reiterated that the stock was a great bargain.²⁴ Meanwhile, Lay himself sold shares worth twenty million dollars during the same period, without disclosure.²⁵ It is also possible that employees respond to real or perceived pressure to buy company stock as a signal of their loyalty to the firm.²⁶

One study indicates that workers tend to extrapolate excessively from a company's past performance to unrealistic expectations about its future.²⁷ Over-investment, therefore, would be especially likely at a company like Enron that had experienced dramatic increases in share prices.

While 401(k) plans are providing a vehicle for worker

²⁰ *Id.* at 4.

²¹ *Id.*

²² See Gordon P. Goodfellow & Sylvester J. Schieber, *Investment of Assets in Self-Directed Retirement Plans*, in POSITIONING PENSIONS FOR THE TWENTY-FIRST CENTURY 67, 86 (Michael S. Gordon et al. eds., 1997).

²³ Joann S. Lublin, *Managers & Managing: As Their Firms Toppled, Some CEOs Prospered*, WALL ST. J. EUROPE, Feb. 27, 2002, at A8.

²⁴ See Allan Sloan, *One Enron Lesson: Some Insider Trading Falls Outside the Timely-Reporting Rule*, WASH. POST, Mar. 5, 2002, at E3 (noting that Lay did not tell employees he had sold significant portions of his own holdings).

²⁵ See *id.*

²⁶ See Christine Dugas, *Don't Bank 401(k) on Employer's Stock: If Company Hits Bad Spot, Retirement Plan Can Tank*, USA TODAY, Aug. 4, 2000, at 3B (noting most companies only provide matching contributions of company stock).

²⁷ See Shlomo Benartzi, *Excessive Extrapolation and the Allocation of 401(k) Accounts to Company Stock*, 56 J. FIN. 1747, 1755-61 (2001) (describing how employees, over-confident about future returns on company stock, tend to over-invest despite the risks of non-diversification).

ownership at a number of companies and company stock comprises a large portion of many employees' retirement accounts, 401(k) shares ordinarily do not represent a significant percentage of an employer's outstanding common stock. For example, at Enron, shares held in 401(k) accounts comprised only two percent of outstanding stock.²⁸ If company stock held in the defined-benefit plan and the Enron ESOP²⁹ were added to these shares, something on the order of five percent of outstanding shares were held for the benefit of Enron employees. Even so, investment of pension assets in company stock will continue to increase absent restrictive legislation. It is therefore conceivable that employee ownership at companies like Enron could reach significant levels in the near future. If stock is otherwise widely held, even a ten percent block can be powerful where the owners are able to coordinate their exercise of voting power. If worker ownership is a desirable objective, company stock investment in defined-contribution plans should be seen as an effective way to achieve that goal.

II. THE COSTS OF NON-DIVERSIFICATION

As Enron's share price fell from a high of nearly ninety dollars to around twenty-five cents, its 401(k) plan—in which 15,000 employees participated—lost 1.3 billion dollars.³⁰ This disaster was not a unique event. For example, at the time of Color Tile's bankruptcy in 1997, ninety percent of the value of its 401(k) plan was invested in the company's own stock.³¹ The effect was to wipe out virtually all of the employees' pension savings. Workers at companies where the 401(k) plan is heavily invested in company stock, such as those mentioned above,³² face

²⁸ ENRON CORP., SCHEDULE 14A, SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS 8 (filed Mar. 27, 2001) (stating that as of February 15, 2001, Enron's defined-contribution plan held 15,409,696 shares (2.04%) of Enron common stock), available at <http://www.enron.com/corp/investors/>.

²⁹ An ESOP ("Employee Stock Ownership Plan") holds common stock of the employer for the benefit of its employees. See 26 U.S.C. § 4975(e)(7) (2002). As of December 31, 2000, Enron's ESOP held 17,241,731 shares of Enron common stock. See ENRON CORP., 2000 ANNUAL REPORT 45 (2001), <http://www.enron.com/corp/investors/>.

³⁰ Louis Uchitelle, *The Rich Are Different: They Know When to Leave*, N.Y. TIMES, Jan. 20, 2002, § 4, at 1.

³¹ Lisa Meulbroek, *Company Stock in Pension Plans: How Costly Is It?* 6 (2002) (unpublished manuscript, on file with author).

³² See *supra* text accompanying notes 20–21.

risk of similar magnitude. While one might insist that companies as large as those cannot fail, it should be recalled that Enron, at the time of its collapse, was number seven on the Fortune 500 list of the largest American companies.³³

A stock price collapse need not be total to have disastrous consequences. Any substantial decline will be very costly if a large percentage of 401(k) assets is invested in company stock. Even at lower percentages, a major drop in market value will be harmful. At Lucent Technologies, for example, company stock comprised only thirty percent of 401(k) plan assets, but the value of that portion of the plan was virtually wiped out when the value of Lucent stock fell from a high of eighty-two dollars to less than one dollar.³⁴

Pension savings diversification takes on added importance when one bears in mind that, for many workers, human capital investments are firm-specific. For these people, the value of workplace knowledge, skills, and relationships acquired over years of service may not be readily transferable to a new employer. Should their current employer fail, these workers stand to lose not only the value of company stock invested in their retirement plans, but also the value of these human capital investments.

A recent paper attempts to quantify the cost of over-investment of pension plan assets in company stock. Muelbroek compares a fully diversified portfolio to one consisting entirely of a single company's stock.³⁵ The latter is far more subject to firm-specific risk but offers no corresponding compensation in the form of higher expected returns. Under reasonable assumptions, Muelbroek concludes that company stock in a non-diversified portfolio may actually be worth as little as forty-two percent of its market value.³⁶

Considering both the irrational propensity of employees to over-invest in company stock and also the potentially high costs of such decisions, a strong case is made for legislative restriction

³³ See Gretchen Morgenson, *How 287 Turned Into 7: Lessons in Fuzzy Math*, N.Y. TIMES, Jan. 20, 2002, § 3, at 1. Of course, we now know that the numbers on which Fortune's ranking were based were at best misleading and possibly fraudulent.

³⁴ Price History of Lucent Technology, at <http://www.moneycentral.msn.com/investor/charts/chartdl.asp?Symbol=Lu> (last visited Oct. 16, 2002).

³⁵ See generally Meulbroek, *supra* note 31.

³⁶ See *id.*

or even prohibition of 401(k) ownership of company stock. One bill currently before Congress would limit company stock in an individual employee's 401(k) account to twenty percent of the account's market value.³⁷ Another would restrict company stock to ten percent of that part of an employee's account attributable to his or her contributions.³⁸ Academic experts have similarly advocated legal regulation to prevent over-investment in company stock. Langbein argues that such holdings should be limited to ten percent of the value of an individual account,³⁹ while Stein supports an absolute prohibition.⁴⁰

The argument for mandatory diversification is even stronger if one bears in mind that this is not simply a matter of individuals making choices and then bearing the consequences of their own mistakes. Inadequate pension income generates social costs as individuals and private and public organizations are called upon to take care of retirees who lack the resources to take care of themselves. Before jumping on the regulatory bandwagon, however, we should pause to consider whether there might be countervailing considerations that counsel in favor of promoting worker ownership through 401(k) plans.

III. ARGUMENTS IN FAVOR OF WORKER OWNERSHIP

A. *Self-Realization Through Work*

Elster has written about a Marxist conception of work that rejects the notion of work as disutility and argues instead that labor can enhance utility by providing a vehicle for self-realization.⁴¹ While the effort involved in work can be unpleasant, it is also possible for work to provide unique opportunities for the full development of an individual's interests and abilities. One condition for self-realization in this sense is a degree of autonomy or self-determination in the workplace. Self-

³⁷ S. 1838, 107th Cong. (2001).

³⁸ H.R. 3463, 107th Cong. (2001).

³⁹ See *The Fall of Enron: How Could it Have Happened?: Hearing Before the Comm. on Governmental Affairs*, 107th Cong. 93 (2002) (statement of John H. Langbein).

⁴⁰ See Norman Stein, *Three and Possibly Four Lessons About ERISA That We Should, but Probably Will Not, Learn from Enron*, 76 ST. JOHN'S L. REV. 855 (2002).

⁴¹ See generally Jon Elster, *Self-Realization in Work and Politics: The Marxist Conception of the Good Life*, in ALTERNATIVES TO CAPITALISM 127 (Jon Elster & Karl Ove Moene eds., 1989).

realization is hard to achieve if an employer dictates to workers the conditions and the end product of the work process. As an alternative to ownership and control by outside investors, worker ownership has the potential to facilitate self-determination in the workplace. Worker ownership therefore can be defended as a means or even a necessary condition for achievement of self-realization through work.

401(k) plan participants typically have the right to vote their shares of company stock.⁴² This was the case at Enron.⁴³ Investment of pension savings in company stock therefore can be a vehicle for participation in control of the business through election of senior management. Ultimately, voting rights can mean control of the workplace itself.

Of course, shareholders' voting rights typically do not bring about effective control over management. At least where ownership is widely dispersed, the costs of collective action among shareholders, each holding a tiny fraction of outstanding stock, are high enough to discourage efforts to organize sizeable voting blocks. The presence of institutional shareholders may lower these costs, but institutions are not necessarily interested in using their voting power to influence the results of annual elections.⁴⁴ The combination of broad dispersion and institutional passivity typically leaves senior management in effective control by default.

Worker owners may face lower collective action costs because they can more readily communicate with each other and are likely to have a stronger sense of common purpose than do widely dispersed outside investors. At companies like Enron, however, the total number of shares owned by employees is not great enough to amount to significant voting power, even if workers voted their shares as a single block.

At Enron, worker ownership evidently did not produce a corporate culture that was conducive to self-realization for most employees. Instead, at least in the important trading segment of

⁴² See Susan J. Stabile, *Pension Plan Investments in Employer Securities: More Is Not Always Better*, 15 YALE J. ON REG. 61, 69 (1998) ("[I]n defined contribution plans, voting and tender rights are typically passed through to plan participants.").

⁴³ See ENRON CORP. SAVINGS PLAN, at VIII-2-VIII-3 (1999).

⁴⁴ See Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 452 (1991) (noting that agency problems deter institutional investors from becoming proactive in the companies whose stock they hold).

the business, work was organized as a tournament. Individuals competed with each other and were rewarded or punished according to their productivity. This kind of environment, in which external pressures dictate the pace and goals of work, probably does not provide an opportunity for personal growth through self-determination. A minimal condition for self-realization would appear to be a level of worker ownership sufficient to establish voting control. Only then would workers be in a position to create a culture in which self-realization could flourish.

B. Elimination of Conflict Between Capital and Labor

The possibility that worker ownership can eliminate conflict between capital and labor could provide a different reason to encourage worker ownership through 401(k) plans. If workers themselves provide a company's capital, the inevitable conflicts between outside investors and their employees might be avoided. Even if workers do not actually own a controlling interest in their corporation through their pension plan, lower levels of stock ownership could still lead employees to think of themselves as owners rather than employees. If this were so, bargaining costs and rent seeking might be reduced.

There does not appear to be a point at which stock ownership necessarily transforms worker attitudes so that a cooperative outlook replaces an adversarial posture. Even where workers own a significant percentage of outstanding stock, conflict between labor and management can persist. This appears to be the case at United Airlines, for example, where workers own fifty-five percent of outstanding stock.⁴⁵ Even though labor owns a controlling interest, several unions maintain a strong presence and seem to exhibit the same kind of confrontational stance toward senior management typically seen in investor-owned firms.⁴⁶

The United Airlines example suggests another point. In a

⁴⁵ Adam Bryant, *No Longer Flying in Formation*, N.Y. TIMES, Jan. 17, 1997, at D1.

⁴⁶ See Bryant, *supra* note 45 (“[T]he unions appear to be ignoring management’s warning that letting labor costs creep too high will undo hard-won gains and damage the carriers’ standing on Wall Street.”); Edward Wong, *United Air’s Family Is Anything But*, N.Y. TIMES, Oct. 6, 2002, §3, at 1 (“Executives at United have traditionally blamed . . . self-serving attitudes of the unions for pushing the airline’s costs sky high.”).

large company, even if worker ownership were to reduce labor-management conflict substantially, it is still possible that significant horizontal frictions—among different groups of workers, such as dissension among pilots, flight attendants, mechanics, and others—could persist. Unavoidable competition for firm revenues among such groups encourages costly rent-seeking activities. Formation of unions may be an example. Worker ownership, as such, will not resolve these kinds of conflicts. It could exacerbate them by eliminating the possibility of a neutral referee capable of moderating such conflicts in a disinterested manner.

C. *Democratic Self-Governance*

The political theorist Robert Dahl has emphasized the connection between worker ownership and democratic self-governance.⁴⁷ Worker ownership allows workers to assert control over their own workplace, rather than being subject to the supervision of managers chosen by investor-owners. Self-government in the workplace can be defended as a good in itself because it respects the values of “liberty and popular sovereignty.”⁴⁸ It can also serve the instrumental end of providing a sort of training ground for active involvement in a democratic society’s political processes.⁴⁹

Democratic self-governance in the workplace implies managerial decision-making power, or at least the power to choose those who will make management decisions. Ownership of a minority interest in a firm dominated by outside investors does not entail these kinds of control. At least at this time, 401(k) plans do not facilitate control because workers do not own enough stock. Although gradual accumulation of company stock in individual retirement accounts could eventually result in significant minority blocks, it is unlikely that such accumulations could create sufficient voting power to provide workers with the opportunity to exert meaningful control over

⁴⁷ See ROBERT A. DAHL, A PREFACE TO ECONOMIC DEMOCRACY 94–99 (1985) (“Workplace democracy . . . will foster human development, enhance the sense of political efficacy, reduce alienation, . . . and stimulate greater participation and better citizenship in the government of the state itself.”).

⁴⁸ SAMUEL BOWLES & HERBERT GINTIS, DEMOCRACY AND CAPITALISM 3 (1986).

⁴⁹ See DAHL, *supra* note 47, at 94–98 (recognizing that while many scholars advocate workplace democracy as a means of inspiring these workers to greater participation in the political process, in actuality, this does not necessarily occur).

corporate governance.

Even if workers did enjoy voting power of sufficient magnitude, self-governance in large corporations is likely to be representative rather than direct. In a large organization, democracy modeled on the "New England town meeting" would surely be an excessively costly distraction from the firm's primary profit-seeking mission. This would not simply be a matter of the numbers of people involved. If production were organized in the form of numerous groups of workers each performing different functions, competing perspectives and interests would exacerbate governance costs because of the likelihood of significant disagreement. Such costs can be high enough even when numbers are small and everyone is engaged in essentially the same activity, as in a law partnership or on a law school faculty.

Because of the significant costs involved in direct democracy, there will always be pressures for worker-owners in larger firms to delegate management responsibility to full-time managers so that the workers can concentrate their energies on production rather than politics. Election of these managers is still a democratic exercise, apparently analogous to the democratic selection of public office-holders. The relationship between worker-owners and their chosen leaders, however, could be qualitatively different from the relationship between governmental officials and their constituents. Having been chosen to produce economic value, business managers need to enjoy a reasonably broad range of decision-making authority that comes at the expense of workers' autonomy. That kind of relationship—involving significant powers of control—differs from elected officials' more limited powers over their constituents. Representative democracy in the workplace, while still involving self-governance in a meaningful sense, nevertheless does not amount to a replica of democracy in the public sphere. Personal autonomy is ceded to a greater degree. The analogy between workplace and political democracy being imperfect, the argument for worker ownership based on self-governance values is not as strong as it might initially appear.

D. Efficiency Considerations

In addition to the arguments sketched above, which are typically advanced by those on the left side of the political

spectrum, hard-nosed proponents of productive efficiency have also pointed to several potential benefits of worker ownership. For these people, values like individual dignity or self-realization are not of primary importance. Instead, worker ownership needs to be evaluated in terms of dollars and cents.

1. Motivation and Productivity

One potential efficiency benefit is the possibility of increased worker effort resulting from the incentive effects of equity ownership.⁵⁰ Non-owner employees are typically compensated by a fixed wage. Their incentive is to work hard enough to earn the wage, but no harder. Enhanced productivity resulting from extra effort would be of no value to the workers because their return is limited by contract; the extra benefits instead go to the shareholders as residual claimants. In contrast, if workers themselves have a stake in the firm's residual income (in effect claiming returns equivalent to wages plus a share of profits), they have an incentive to increase their effort levels beyond the bare minimum necessary to avoid discharge in an investor-owned company.

Plausible as these ideas might seem, the incentive question probably is more complex, rendering this argument doubtful at the theoretical level. Even if workers own stock in their companies, they must still decide whether increased effort is worthwhile. In a public company, no single worker's level of effort (at least no worker below the highest levels of the managerial hierarchy) makes a difference to the corporation's bottom line. An individual may wish that everyone else would work harder and thereby improve corporate performance, but if that were to happen all shareholders would benefit regardless of whether they contributed to the improvement. Individual workers therefore have no reason to increase their own effort. This would appear to be a classic "free-rider" scenario.⁵¹ In any

⁵⁰ Because the Bush Administration believes that contributions of company stock provide a positive incentive to employees, its pension reform proposal does not include restrictions on the amount of company stock in individual 401(k) accounts. The proposal would, however, give employees the freedom to sell such shares after they have participated in the employer's plan for three years. See President George W. Bush, Remarks by the President on Retirement Savings (Mar. 1, 2002), at <http://www.whitehouse.gov/news/releases/2002/03/20020301-2.html>.

⁵¹ See Joseph Blasi et al., *Employee Stock Ownership and Corporate Performance Among Public Companies*, 50 INDUS. & LAB. REL. REV. 60, 61 (1996)

event, individual ownership stakes are so small that increases in share price will not significantly increase anyone's personal wealth.

In contrast, the incentive effects of equity ownership by high-level management are quite different. These people often own (or have options to buy) a large enough number of shares. For them, an increase in stock price can be very valuable. They are also in a position individually to do things that enhance stock price.⁵² These differences can be sufficient to negate the free-rider tendencies to which lower-level workers are subject.

Turning from theory toward empirical studies, one finds inconclusive results on the productivity benefits of worker versus investor ownership. Kruse and Blasi, having surveyed the research in this area, conclude that "[t]here is no automatic connection between employee ownership and firm productivity and profitability . . ."⁵³ They also infer from their empirical work that worker ownership does not necessarily result in better attitudes, motivation, or behavior in the workplace.⁵⁴ However, where motivational improvements are found, "they are almost always linked to the status of being an employee-owner, and not to the size of one's ownership stake."⁵⁵ In such cases, participation in decision-making seems to be an important factor.⁵⁶

These findings suggest, at best, qualified support for encouragement of worker ownership through 401(k) plans. Motivational and productivity gains can follow from worker ownership even if stakes are small, especially if there is also meaningful worker participation in workplace decision-making. Evidently there is more involved here than rational choice theory

(discussing how free-rider problems "among employees limit the incentive effects of group based reward systems").

⁵² Recent events, including the Enron scandal itself, indicate that the rewards of enhanced stock prices are sufficient to induce efforts to boost share value by illegal, as well as legal, means. See generally David Millon, *Why Is Corporate Management Obsessed With Quarterly Earnings and What Should Be Done About It?*, 70 GEO. WASH. L. REV. (forthcoming 2002) (discussing earnings management and earnings inflation as mechanisms for boosting share prices artificially).

⁵³ Douglas L. Kruse & Joseph R. Blasi, *Employee Ownership, Employee Attitudes, and Firm Performance: A Review of the Evidence*, in HANDBOOK OF HUMAN RESOURCES MANAGEMENT 113, 144 (Daniel J.B. Mitchell et al. eds., 1997).

⁵⁴ See *id.* at 143.

⁵⁵ *Id.*

⁵⁶ See *id.*

alone might predict. At the same time, however, ownership does not necessarily generate productivity gains, so that argument by itself is insufficient. Ownership needs to be combined with other conditions—apparently having to do with workplace culture and organization—before efficiency increases can be realized.

Looking at Enron, if in fact this was a high motivation, high productivity workplace, it would appear that factors other than stock ownership would explain such to be true. A system of well-defined rewards (compensation and opportunities for promotion) and punishments (threat of demotion or termination) was unrelated to stock ownership as such. As workers saw the value of Enron stock in their 401(k) accounts grow dramatically, this may have provided them with an additional incentive, but it was probably not the primary one. More needs to be discovered about Enron's culture and the attitudes and performance of its workforce, but Enron's story appears to be consistent with empirical findings indicating that worker ownership is only one among a range of factors bearing on worker motivation and productivity. If so, Enron illustrates the error in simplistic assumptions about the incentive effects of stock ownership.

2. Trust

The incentive story is complex and ultimately indeterminate, its relevance apparently dependent on firm-specific cultural and organizational differences. A second potential efficiency advantage of worker ownership could be the potential for reducing employees' distrust of management.

Trust can yield several important benefits, each based on reduced fear of managerial opportunism.⁵⁷ These can include a greater willingness to link compensation to productivity. Workers will tend to prefer a fixed wage if they are distrustful of management but may be willing to accept more flexible compensation arrangements if they have faith in management's honesty.⁵⁸ In addition, employees who trust management should be willing to share their own first-hand knowledge about

⁵⁷ See generally Alan Hyde, *In Defense of Employee Ownership*, 67 CHI.-KENT L. REV. 159, 163–64 (1991) (arguing that an ownership interest for workers can reduce information costs and increase trust, potentially increasing firm productivity).

⁵⁸ See *id.* at 200–01 (concluding that a flexible compensation schemes should be more efficient because it provides the necessary incentives to motivate employees to work hard).

potential sources of productivity gains if they have confidence that management will share these gains with them and will refrain from using that information to bring about layoffs.⁵⁹ Trusting employees should also be more willing to invest in firm-specific human capital.⁶⁰ They may be reluctant to do this if they fear forfeiture resulting from premature discharge but may overcome this reluctance if they have faith in management's good will.

Unlike increased motivation and productivity, which apparently can result from relatively small ownership stakes if other factors are present, trust would seem to depend ultimately on worker control of management. Even well intentioned managers may be unable to gain employees' trust if they have been selected by outside investors rather than by the workers themselves. Workers need assurance that management will act in their best interests in order for them to overcome their reluctance to expose themselves to the risk of opportunism. At a minimum, this should mean shared ownership sufficient to yield voting control. In a public corporation, this ordinarily means at least a substantial minority block. And, as noted above, even majority ownership will not necessarily eliminate conflict between labor and management.⁶¹

The typical 401(k) plan does not include nearly enough company stock to confer voting control on workers. Certainly this was the case at Enron. Worker ownership through 401(k) plans, therefore, is not a realistic vehicle for promoting trust between workers and management.

3. Governance Savings

Worker ownership has the potential to reduce agency and monitoring costs. Agency costs arise whenever a principal hires an agent to act on his or her behalf. An agent will not work as hard for the principal as the principal would because the agent does not fully realize the gains resulting from his or her efforts. The principal can monitor the agent's performance but this is costly. In addition, at some point the marginal cost of monitoring exceeds the marginal benefit; the agent therefore will retain some measure of freedom to shirk his or her

⁵⁹ See *id.* at 200.

⁶⁰ See *id.* at 201.

⁶¹ See *supra* text accompanying notes 57-60.

responsibilities.⁶²

In the typical investor-owned firm, there are two layers of agency costs, as investors hire managers to monitor workers. Worker ownership has the potential to eliminate both layers.⁶³ If workers can monitor each other's performance, no agents need be involved and associated costs can be eliminated. Savings can also flow from the fact that workers may be better positioned than supervisors to keep track of their fellow workers' efforts. They also have a stronger incentive to be attentive because the resulting savings redound to their own benefit.

Worker self-governance presumably requires voting control. If instead control resides with outside investors, they will insist on hiring managers who will manage in their interest. They cannot leave management responsibility in the hands of the workers because, as fixed rather than residual claimants, employees will make decisions with an eye toward generating revenues sufficient to pay themselves rather than seeking to maximize return on the firm's assets. To protect their interests, investors therefore must rely on agents.

Even if workers own enough stock to constitute voting control, if the firm is reasonably large, they may find that it makes no economic sense to attempt to manage it themselves. The costs of self-governance may be excessive.⁶⁴ These costs can include both the time and energy involved in reaching agreement about policy matters and also the cost of measuring and evaluating implementation of those decisions.⁶⁵ Accordingly, worker-owners may choose to reduce these costs by hiring managers, even though that decision involves costs of its own, including compensation and monitoring expenses as well as the unavoidable costs of sub-optimal performance. Like investor-owners, workers may find that they can use their time more

⁶² See generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

⁶³ See generally Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972) (suggesting that worker ownership can be a response to monitoring difficulties).

⁶⁴ See Henry Hansmann, *When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy*, 99 YALE L.J. 1749, 178-82 (1990) (discussing various governance costs, including vast amounts of time and effort).

⁶⁵ See *id.* at 1781.

profitably by doing things other than attempting to manage the firm, namely producing goods or services for sale.

Significant governance cost savings by means of worker ownership probably are realizable only at relatively small companies. In large companies like Enron, 401(k) plans do not own enough company stock to provide workers with the control necessary to establish self-governance. Even if they did, it is likely that worker-owners would need to rely on agents just as investor-owners do. Savings in governance costs therefore do not justify promotion of worker ownership through 401(k) plans.

CONCLUSION

Enron graphically illustrates the risks workers face when they over-invest their pension savings in their company's stock. Having already invested their firm-specific human capital in their employer, they increase the costs of firm failure to the extent they fail to diversify their 401(k) investments. These considerations provide ample reason for the legislatively mandated diversification that Congress is considering. Before endorsing the wisdom of such reforms, however, some attention to another aspect of this issue seems appropriate. Because of the proliferation of tax-advantaged 401(k) retirement plans and the absence of limits on investment in company stock, the 401(k) plan represents the most convenient and economically attractive means for workers to participate in the ownership of their own companies. A range of arguments has been advanced in favor of worker ownership, from the left as well as the right sides of the political spectrum. These include promotion of individual self-realization and democratic decision-making in the workplace, reduction of labor-management conflict, and several potential efficiency benefits. Examined in the context of Enron, it turns out that none of these arguments amounts to a compelling reason for encouraging worker investment in company stock. The case for mandatory diversification therefore is strong.

