Notre Dame Law Review

Volume 75 | Issue 1 Article 2

10-1-1999

Mandated Vesting: Suppression of Voluntary Retirement Benefits

Peter M. van Zante

MANDATED VESTING: SUPPRESSION OF VOLUNTARY RETIREMENT BENEFITS

*Peter M. van Zante**

* Associate Professor of Law, Widener University School of Law, Harrisburg, Pennsylvania. J.D., University of Chicago; B.A., Colorado College. This Article benefited greatly from comments received during faculty seminars at Mercer University School of Law. Dennis S. Corgill, Alan Gunn, Lawrence A. Frolik, Saul Levmore, Harold S. Lewis, Jr., Marc Linder, Malcolm L. Morris, Loren D. Prescott, Jr., Robert C. Power, Jack Lee Sammons, Jr., Jeffrey G. Sherman, and Edward A. Zelinsky provided suggestions and advice that improved the Article. Valuable research assistance was provided by Brian Daughdrill and Michael A. Kauffman. The Article's remaining shortcomings are the author's responsibility.

INTRODUCTION

The Employee Retirement Income Security Act,[1] commonly known as ERISA, mandates that when a retirement plan[2] provides re-

1 Employee Retirement Income Security Act of 1974, §1 (CCH 1999) [hereinafter ERISA]. ERISA was enacted as Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified as amended in scattered sections of 26, 29 U.S.C.) [hereinafter ERISA of 1974]. Titles I, III, and IV of ERISA of 1974 are codified as amended at 29 U.S.C. §§ 1001–1461 (1994 & Supp. 1997). Provisions of Titles I, III, and IV of ERISA of 1974 as amended are often cited to ERISA sections. Title II of ERISA of 1974 amended scattered sections of the Internal Revenue Code. *See* I.R.C. §§ 1–9833 (1994 & Supp. III 1997). Together, ERISA and the retirement plan provisions of the Internal Revenue Code comprise the law governing retirement plans.

2 This Article uses the terminology "retirement plan" to refer to "tax-qualified" retirement plans that are sponsored by an employer and that provide retirement benefits to that sponsoring employer's employees. The term is used to refer only to plans that are "qualified" for special income tax treatment under Internal Revenue Code

tirement benefits to an employee, the employee's rights to those benefits must vest, that is become nonforfeitable,[3] when the employee has completed a certain minimum period of service with the employer.[4] Congress intended that mandated vesting would increase the amount of retirement benefits to be received by some retirement plan participants.[5] It may seem obvious that mandated vesting would have this effect, since accelerated vesting implies that some plan participants will not forfeit otherwise unvested benefits, and fewer and smaller for-

---

§ 401 and § 501(a). *See* I.R.C. §§ 401, 501(a) (1994 & Supp. III 1997); *see also infra* notes 34–47 and accompanying text. The retirement plans discussed in this Article are included in the term "employee pension benefit plan" as defined by ERISA. *See* ERISA § 3(2)(A), 29 U.S.C. § 1002(2)(A) (1994). This analysis is limited to plans sponsored by private, for-profit employers. Virtually all retirement plans sponsored by private, for-profit employers are subject to ERISA. *See* ERISA § 4, 29 U.S.C. § 1003 (1994 & Supp. III 1997). *See generally* Peter J. Wiedenbeck, *ERISA's Curious Coverage*, 76 WASH. U. L.Q. 331 (1998).

This Article excludes plans that are sponsored by governmental employers, churches, and retirement savings arrangements connected with employers that are nonprofit organizations such as educational institutions. Also excluded are plans that have been the subject of collective bargaining between an employer and employees; these plans are often referred to as "union retirement plans." Many union retirement plans are described by the ERISA definition of a "multiemployer plan," a plan that covers the employees of more than one employer and is maintained pursuant to a collective bargaining agreement. *See* ERISA § 3(37)(A), 29 U.S.C. § 1002(37)(A) (1994).

3 ERISA provides,

> The term "nonforfeitable" when used with respect to a pension benefit or right means a claim obtained by a participant or his beneficiary to that part of an immediate or deferred benefit under a pension plan which arises from the participant's service, which is unconditional, and which is legally enforceable against the plan.

ERISA § 3(19), 29 U.S.C. § 1002(19) (1994).

4 ERISA sets out three alternative minimum standards for vesting—"five-year cliff vesting," "seven-year graded vesting," or "100% immediate vesting." ERISA §§ 202(a)(1)(B)(i), 203(a)(2), 29 U.S.C. §§ 1052(a)(1)(B)(i), 1053(a)(2) (1994 & Supp. III 1997). The identical rules are repeated as income tax qualification requirements in the Internal Revenue Code. *See* I.R.C. §§ 410(a)(1)(B)(i), 411(a)(2) (1994 & Supp. III 1997); *see also infra* note 98 and accompanying text.

5 *See infra* note 117 and accompanying text. The private retirement plan system is an extremely significant institution. There are 702,000 private retirement plans in the United States, and these plans provide benefits to 84,000,000 participants. *See* KEN MCDONNELL ET AL., EBRI DATABOOK ON EMPLOYEE BENEFITS 84, 98 (Employee Benefit Research Institute, 4th ed. 1997). In 1995 these plans held $5.5 trillion, which approaches the value of all the residential real estate in the United States. *See* Sylvester J. Schieber & John B. Shoven, *The Economics of U.S. Retirement Policy: Current Status and Future Directions*, *in* PUBLIC POLICY TOWARD PENSIONS 1 (Sylvester J. Schieber & John B. Shoven eds., 1997).

feitures must equate with larger benefits being paid to retired participants.

In reality, *mandated vesting will not increase the retirement benefits of its intended beneficiaries, and it will reduce the retirement benefits of other retirement plan participants.* By definition, mandated vesting is intended to increase the retirement benefits of plan participants who otherwise would be unvested, a group of participants that this analysis refers to as "short-tenure employees."[6] A fundamental reason that mandated vesting cannot, in the long run, increase the retirement benefits of short-tenure employees is the fact that the private retirement plan system is *voluntary.* No law requires an employer to provide employees with retirement benefits or requires employees to save any part of their compensation for future retirement needs. In a world without mandated vesting, the mix of wage compensation and retirement benefits in an employee's total compensation package would reflect the employer's and employee's preferences for wages and fringe benefits.[7] Mandated vesting attempts to provide short-tenure employees with larger retirement benefits than they would voluntarily choose. Over time, retirement plans will reduce their benefit levels to eliminate the benefits that mandated vesting attempts to extend to short-tenure employees.

Mandated vesting will, in the long run, cause a reduction in the retirement benefits of retirement plan participants other than the short-tenure employees. Retirement plan law includes nondiscrimination rules, which, in general terms, compel a retirement plan to provide benefits to "non-highly compensated employees" that are reasonably comparable to the benefits provided "highly compensated employees."[8] The nondiscrimination rules prevent a retirement plan from responding to mandated vesting by reducing only the benefits of short-tenure employees. The benefits of other participants in the plan will also have to be reduced. Generally these other plan participants have stronger preferences for retirement benefits than the

6 *See infra* note 124 and accompanying text. The term "short-tenure employees" has no normative content; the term is used to identify exactly those employees who receive larger vesting percentages because of legal mandates. There is no presumption that employees who have relatively shorter job tenures are somehow less deserving of retirement benefits. This analysis develops the effects that mandated vesting has on the private retirement plan system. These effects might influence a reader's opinion about the appropriate structure of retirement plan law, and how the law might affect the retirement benefits to be received by particular categories of employees.

7 These preferences would be influenced by other elements of the legal environment, including the federal income tax. *See infra* notes 35–48 and accompanying text.

8 *See infra* note 227 and accompanying text.

short-tenure employees. The combination of mandated vesting and the nondiscrimination regime drastically limit the plan's flexibility to provide retirement benefits to those employees who most highly value the benefits. As the plan's ability to provide retirement benefits to those employees who prefer the benefits is diminished, the plan becomes a less valuable compensation mechanism for the sponsoring employer and its workforce. As plans suffer this loss in value, fewer will be sponsored.[9]

Today, proposals abound for further acceleration of the vesting mandates.[10] Proponents continue to assert that quicker vesting will enhance the retirement benefits that employees will receive.[11] This article disproves that assertion. Part I develops the fundamental explanation for the failure of mandated vesting: the fact that retirement plan sponsorship is voluntary. A retirement plan can exist only so long as it creates additional value for the sponsoring employer and participating employees. If legal regulation of a plan makes it impos-

---

9 *Cf.* Norman Stein, *ERISA and the Limits of Equity*, 56 LAW & CONTEMP. PROBS. 71, 109 (1993) ("These notions of regulation and encouragement [of employee benefits] are not entirely compatible. The greater the degree of regulation of plans, the greater the direct and indirect costs to the plan sponsor. The greater these costs, the lower the size of benefits and the rate of plan formation.").

10 *See* JOHN A. TURNER, PENSION POLICY FOR A MOBILE LABOR FORCE 124 (1993) ("Private pension portability would be improved by requiring shorter vesting. . . . Vesting could be reduced to three-year cliff vesting or could occur immediately. Immediate vesting would reduce the benefits the average pension-covered worker loses by four percent. . . ."). For current legislative proposals, see, for example, Taxpayer Refund and Relief Act of 1999, H.R. 2488, 106th Cong. § 1223 (approved by both House and Senate on Aug. 5, 1999, but vetoed by the President on Sept. 23, 1999) (mandating that employer matching contributions under a § 401(k) plan must vest according to either a three-year cliff vesting schedule or a six-year graded vesting schedule); H.R. 352, 106th Cong. §§ 2–3 (1999) (creating a new variant of a defined contribution plan, a "qualified small employer plan," which must provide vesting according to either a three-year cliff vesting schedule or a six-year graded vesting schedule). Proposals for immediate full vesting are not a recent phenomenon. *See* Russell K. Osgood, *Qualified Pension and Profit-Sharing Plan Vesting: Revolution Not Reform*, 59 B.U. L. REV. 452, 453, 465–75 (1979) (proposing that ERISA and the I.R.C. be amended to require immediate full vesting).

11 *See, e.g.*, TURNER, *supra* note 10, at 124. A very significant precursor of ERISA was the PRESIDENT'S COMM. ON CORP. PENSION FUNDS AND OTHER PRIVATE RETIREMENT AND WELFARE PROGRAMS, PUBLIC POLICY AND PRIVATE PENSION PROGRAMS: A REPORT TO THE PRESIDENT ON PRIVATE EMPLOYEE RETIREMENT PLANS (1965) [hereinafter WIRTZ REPORT]. A central concern of the *Wirtz Report* was the extent of vesting in private retirement plans. *See id.* at 27–46. ERISA's vesting provisions have proven to be of great importance: "ERISA's creation of federal vesting standards for pension plans has had a pronounced effect on the benefit contract." Stein, *supra* note 9, at 72 n.8 (citations omitted).

sible for the plan to provide retirement benefits to a group of employees who value those benefits more highly than alternative forms of compensation, the plan will be terminated.

Part II summarizes the vesting problem and the law of mandated vesting and begins analysis of the justifications and effects of legal regulation of retirement plan vesting. It might appear that the effect of mandated vesting is to redistribute retirement benefits from other retirement plan participants to short-tenure employees. However, this redistribution of retirement benefits is not a stable arrangement; in the long run, further adjustments to the plan must occur. These long-run effects of mandated vesting are developed in subsequent parts of the article.

Before considering additional effects of mandated vesting, Part III explores the full regulatory implications of mandated vesting. Section A demonstrates that effective implementation of mandated vesting requires regulation of all other important aspects of retirement plan design, including employees' participation, benefit accrual, and benefit payment. Section B explicates the nondiscrimination rules. It is impossible to analyze the effects of mandated vesting without considering the nondiscrimination regime. The mandated vesting and nondiscrimination regimes enjoy a symbiotic relationship. Section C shows that the nondiscrimination regime will ensure that some short-tenure employees will participate in a retirement plan and thereby accrue benefits. Mandated vesting ensures that some benefits that accrue to these short-tenure employees will actually be paid to them. The combination of mandated vesting and the nondiscrimination regime attempts to compel a retirement plan to provide retirement benefits to short-tenure employees.

Part IV returns to the analysis of the effects of this effort to mandate retirement benefits. Section A explains that in the long run, mandated vesting will not increase the retirement benefits of short-tenure employees. Over time, the costs of retirement benefits are borne by the employees who receive those benefits, and short-tenure employees will be unwilling to trade wages for additional retirement benefits. A retirement plan must eliminate the additional benefits mandated by the vesting rules, and return the retirement benefits provided to short-tenure employees to a pre-mandate level. Section B shows that when retirement benefits are reduced for short-tenure employees, the nondiscrimination regime will compel similar reductions in the benefits of other employees. In effect, mandated vesting reduces the retirement benefits of other employees. Section C explains how the combined regulatory regime of mandated vesting and nondiscrimination rules drastically limits the extent to which a retirement plan can be designed to provide retirement benefits to those employees who will value the benefits most highly. This implies that fewer retirement plans will be created and that some existing retirement plans must be terminated. Thus, mandated vesting reduces the number of retirement plans.

Part V explores some broad implications of the analysis. Part VI offers a brief conclusion: great caution should be exercised before lawmakers impose a further acceleration of the time for mandated vesting of retirement benefits. Those who would prescribe additional mandated vesting as a cure for insufficient retirement benefits ought to bear a burden of persuasion that their prescription will provide a net improvement for the participants in our voluntary retirement plan system. To those who would prescribe a single prescription for a diverse economy, it must be said, "Above all do no harm."[12]

I. Voluntary Retirement Plans

A. *Voluntarism*

The creation of a private retirement plan is voluntary in the sense that there is no legal requirement that an employer provide its employees with retirement benefits, nor that employees set aside a portion of their earnings as retirement savings. The Supreme Court has stated the rule plainly: "Nothing in ERISA requires employers to establish employee benefits plans. Nor does ERISA mandate what kind of benefits employers must provide if they choose to have such a plan."[13] Since sponsorship of a plan is voluntary, it follows that the type and amount of benefits to be provided by a particular plan are also voluntary choices. As part of the initial establishment of a retirement plan, the plan will specify the amount or level of contributions that will be paid to the retirement plan, or the level of benefits that will be paid by the plan to retired employees.[14] The revision, continuation, and termination of a retirement plan are also voluntary; if the sponsoring

12 This phrase is often attributed to Hippocrates, but it is not found in his works. Its origin is obscure. *See* W.H.S. Jones, Hippocrates (1923).

13 Lockheed Corp. v. Spink, 517 U.S. 882, 887 (1996) (citing Shaw v. Delta Air Lines, Inc., 463 U.S. 85, 91 (1983), and Alessi v. Raybestos-Manhattan, Inc., 451 U.S. 504, 511 (1981)); *see also* Bruce Wolk, *Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality*, 70 Va. L. Rev. 419, 430 (1984) ("Of course, the employer is the one who makes the decision to establish a retirement plan."). *See generally* John H. Langbein & Bruce A. Wolk, Pension and Employee Benefit Law 127 (1995); Catherine L. Fisk, *Lochner Redux: The Renaissance of Laissez-Faire Contract in the Federal Common Law of Employee Benefits*, 56 Ohio St. L.J. 153, 157–61, 170–72, 171 n.61 (1995).

14 *See infra* notes 22–33 and accompanying text.

employer or the participating employees decide that the plan no longer adds value, the plan can be revised or terminated by action of the sponsoring employer.[15] As a matter of form, it is the employer that establishes a retirement plan, determines the content of the plan document, and terminates the plan.

The formality of the employer's apparently unilateral control over the retirement plan obscures a more important reality: a retirement plan reflects the preferences and choices of the employees who participate in the plan. The plan is one component of the entire relationship between an employer and its employees, and retirement benefits are but one form among the many in which compensation may be paid to employees. Wages typically comprise the largest portion of employees' compensation packages, but those packages usually include several types of in-kind compensation.[16] When an employee earns rights, whether vested or unvested, to (perhaps) receive retirement benefits in the future, the employee has received in-kind compensation. The total cost of employees' compensation packages, including wages and fringe benefits, is limited by an employer's compensation budget.[17] When employees receive compensation in the form of retirement benefits, they will necessarily receive lesser amounts of other forms of compensation.

An employer will create a plan to provide retirement benefits, and employees will receive compensation in that form when the employees participating in the plan prefer retirement benefits to other forms of compensation. Different employees will have different preferences about retirement benefits as a form of compensation.[18] A sponsoring employer aims to provide that level and structure of retire-

15 ERISA requires that "[e]very employee benefit plan shall . . . provide a procedure for amending such plan, and for identifying the persons who have authority to amend the plan. . . ." ERISA § 402(b), 29 U.S.C. § 1102(b) (1994). Typically a retirement plan provides that the sponsoring employer has the authority to amend the plan. The authority to amend the plan includes the authority to terminate a plan.

16 The term "wages" refers to money compensation paid to employees at approximately the same time that the employees provide services to the employer. Wages are contrasted with fringe benefits (for example, health insurance) which are various forms of in-kind compensation. Wages do not include deferred compensation (such as retirement benefits) which is paid in money but is paid perhaps many years after services have been rendered.

17 *See infra* note 257 and accompanying text.

18 One powerful explanation of the differing preferences of employees stems from the income tax treatment of retirement benefits. *See infra* notes 35–48 and accompanying text.

ment benefits that its workforce values most highly.[19] An employer does not gratuitously provide retirement benefits to its employees, nor can it unilaterally dictate the portion of employees' compensation that will be received in the form of retirement benefits. Instead, a retirement plan is a device by which both the employer and employees can realize additional value from the resources available to compensate employees. From this perspective, it can be seen that a particular retirement plan structure reflects the compensation preferences of the employer's workforce. While as a matter of form, the sponsoring employer seems to control a retirement plan, in substance, the employer must satisfy the preferences of its workforce by providing that level and structure of retirement benefits that its workforce values most highly.

B. *Retirement Plan Taxonomy*

The principle of voluntarism in the retirement plan system applies only to the fundamental choices to establish a retirement plan, to determine the type and level of benefits, and ultimately to termi-

19 The analysis in this Article assumes that, in general and on average, employers that sponsor retirement plans will act to maximize the value of their expenditures on employee compensation, whether it is paid in the form of wages, retirement benefits, or other forms of fringe benefits. Similarly, the analysis assumes that employees will prefer employment that offers them the highest total value, or "utility," in exchange for the time and effort that they expend during their workings hours. In this sense, the analysis is economic; it assumes "that man is a rational maximizer of his ends in life, his satisfactions—what we shall call his 'self-interest.'" RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 3–4 (5th ed. 1998).

It is appropriate to analyze private retirement plans and the benefits they provide from an economic perspective. Since the private retirement plan system is voluntary, all sponsoring employers and plan participants have exercised some degree of choice in participating in the system in the first place. These choices are heavily, if not exclusively, influenced by economic considerations. Sponsoring employers must respond to the legal environment in economically rational ways; employers who face competition in their labor supply markets or product or service markets must spend their employee compensation budgets efficiently or be driven out of business by other employers who operate more efficiently. *See infra* notes 254–61 and accompanying text. Employees also face choices that can be understood in economic terms. So long as retirement plan sponsorship is voluntary, some employers will offer employment that includes retirement benefits, and others will not. Economic analysis suggests that employees will sort themselves among employers in part based upon the employees' various preferences for wages or for other forms of compensation, such as retirement benefits. If particular aspects of retirement plan law have generally predictable effects upon employer and employee choices, then analysis from an economic perspective may enlighten us about the effects of retirement plan law on the future retirement income security of American workers.

nate the plan. Beyond these basic decisions, there are drastic limitations on the freedom of an employer and its employees to agree upon the structure of retirement benefits that they might include as part of employees' compensation. The Internal Revenue Code creates a special income tax regime for "tax-qualified retirement plans;" the price of qualification for this income tax treatment is conformity to a system of minute regulation of a retirement plan.[20] ERISA simply outlaws certain forms of retirement benefits. For example, retirement benefits must vest no later than upon an employee's completion of seven years of service; if a retirement plan required that an employee attain age sixty-five before she was entitled to receive benefits, the sponsoring employer and the plan would be subject to a variety of legal sanctions. Once an employer and its employees have chosen to join the retirement plan system, every aspect of their retirement plan is subject to pervasive regulation.

If an employer sponsors a retirement plan, ERISA demands that all contributions paid to fund future benefits must be segregated in a separate retirement trust.[21] These contributions are held and invested and the resulting accumulations are used to pay the retirement benefits when participating employees ultimately retire. Depending upon how a plan determines the amount of retirement benefit to be paid to a retired participant, it is classified as either a "defined contribution plan,"[22] or it falls into the residual category, a "defined benefit

---

20 As a practical matter, if retirement benefits are to be provided to employees, other than a very limited group of the highest paid executive employees, the benefits must be provided by a tax-qualified retirement plan. *See infra* notes 35–48 and accompanying text.

21 *See* ERISA § 403(a), 29 U.S.C. § 1103(a) (1994). As a structural matter, an employer that sponsors a retirement plan is obligated to create a separate trust fund, referred to as a "retirement trust," that holds the funds accumulated to pay the retirement benefits. *See id.* Insurance contracts can serve the trust function in certain circumstances. *See* ERISA § 403(b), 29 U.S.C. § 1103(b) (1994). The retirement trust is irrevocable, and once paid to the retirement trust, an employer's contributions are not returnable to the employer except in very limited circumstances. The retirement trust is not subject to claims of the employer's creditors. Retirement benefits are paid entirely from the retirement trust fund. *See id.* The retirement trust provides both the employer and the employees with the security of advanced, segregated, and exclusively dedicated funding for the retirement benefits. The trust requirement is repeated in the Code. *See* I.R.C. § 401(a)(2) (1994).

22 I.R.C. § 414(i) (1994); ERISA § 3(34), 29 U.S.C. § 1002(34) (1994). A defined contribution plan is a plan that bases a participant's benefit on that participant's individual account, which represents that participant's share of the plan's total assets. *See id.* *See generally* Norman P. Stein, *Qualified Plans and Tax Expenditures: A Reply to Professor Zelinsky*, 9 AM. J. TAX POL'Y 225, 228–29 (1991).

plan."[23] Under a defined contribution plan, the amounts that the sponsoring employer will contribute to the plan are defined in the document that creates the plan.[24] For example, in a particular species of defined contribution plan known as a "money purchase pension plan," the plan specifies that the employer will contribute a fixed percentage, for example ten percent, of each participating employee's compensation for each year of participation; this specified contribution is the defined contribution.[25] This defined amount contributed on behalf of each employee is allocated within the retirement trust to that employee by means of a bookkeeping account, which is referred

---

23 I.R.C. § 414(j); ERISA § 3(35), 29 U.S.C. § 1002(35) (1994). Technically the statutes define a "defined benefit plan" as the residual category of retirement plans, including all retirement plans that are not defined contribution plans. *See id.* The technical statutory definition reflects the operational reality of retirement plans: if a plan does not base a participant's benefit on that participant's individual account, the plan necessarily must express the participant's benefit as a fixed, or defined, benefit. *See* 1 MICHAEL J. CANAN, QUALIFIED RETIREMENT AND OTHER EMPLOYEE BENEFIT PLANS § 3.51 (1997); PAMELA D. PERDUE, QUALIFIED PENSION AND PROFIT-SHARING PLANS ¶1.03[3][a] (1994).

24 If the employer sponsors a species of defined contribution plan known as a profit-sharing plan, the amount contributed may be varied, or even reduced to zero, from year to year; this variability of contributions distinguishes a profit-sharing plan from a pension plan. As a matter of form, the sponsoring employer determines the amount contributed to a profit-sharing plan. As a matter of substance, the profit-sharing contributions depend upon the expectations of the employer and of the participating employees. These expectations can be embodied in a relatively definite understanding about a relationship between the sponsoring employer's financial profits in a given year and the amount of the plan contribution. Alternatively, an employer might be given "discretion" to determine the amount of the contribution, but the employer would exercise this discretion in light of employee perceptions and expectations. The annual flexibility in the amount of contributions to a profit-sharing plan is the essential factor that distinguishes a profit-sharing plan from a pension plan. *See* Treas. Reg. § 1.401-1(b)(1)(ii) (as amended in 1976). Internal Revenue Code § 401(a)(27) eliminates the requirement that contributions to a profit-sharing plan be made from the employer's profits. *See* I.R.C. § 401(a)(27)(A) (1994).

In contrast, the benefits paid by a defined benefit pension plan must be definitely determinable, *see* Treas. Reg. § 1.401-1(b)(1)(i) (as amended in 1976), and the employer is obligated to contribute amounts to the plan sufficient to adequately fund the benefits. *See infra* note 33 and accompanying text. The requirement of definitely determinable benefits does not apply to a money purchase pension plan; instead, a sponsoring employer must undertake a fixed commitment to contribute specified amounts to the money purchase pension plan. *See* Tres. Reg. § 1.401-1(b)(1)(i).

25 *See* Treas. Reg. §§ 1.401-1(b)(1)(i). For example, the plan might specify that the employer would contribute 10% of each participating employee's compensation to the retirement trust during each year that an employee participated in the plan. If the plan is a profit-sharing plan, it could provide that the employer would contribute that amount which the employer determined each year to pay as a contribution.

to as that employee's "individual account" or "participant's account." Each participant's account states the total value of the assets that are allocable to, and held for the benefit of, that participant; this amount is referred to as the participant's accrued benefit.[26] When the participant qualifies to receive retirement benefits, the amount held in the participant's individual account is paid to her as her retirement benefit. The defined contribution plan takes its name from this mode of operation: the plan specifies—that is, defines—the contributions that will be paid by the employer during a participant's working career.[27] However, the amount of retirement benefits that a participant will ultimately receive is indeterminate—undefined—until the participant actually receives the benefits.

If a retirement plan does not maintain individual participants' accounts and does not determine each participant's benefit with reference to that account balance, then the plan is a defined benefit plan.[28] Typically, a defined benefit plan promises to pay to each participant a retirement benefit in an amount defined by the plan document, a "defined benefit."[29] The defined retirement benefit is usually a pension of a specified amount payable monthly, beginning at some future date (for example, upon the participant's attaining age 65) and continuing until the retired participant's death.[30] The amount of the pension is computed by application of a benefit formula; usually the benefit formula is based upon a participant's years of service and compensation history through the date of the benefit computation.[31] As

26 The investment gains and losses of the trust fund are allocated at the end of each plan year proportionately among the participants' accounts.

27 All retirement plans must be funded plans. *See* ERISA § 403(b), 29 U.S.C. § 1102(b) (1994). The mechanics of funding differ very significantly between defined contribution plans and defined benefit plans. In a defined contribution plan, each participant's account determines the amount that will be paid to the participant as a retirement benefit. Since each participant's retirement benefit is equal to the amount of assets which are allocated to her participant's account (plus all investment gains or losses allocated to those assets), a defined contribution plan is always, by definition, a fully funded plan.

28 *See* I.R.C. § 414(j) (1994); ERISA § 3(35), 29 U.S.C. § 1002(35) (1994).

29 For example, a participant's retirement benefit would be defined as a pension of $500 per month beginning when the participant attained age 65 and continuing for the life of the participant. *See* Treas. Reg. §§ 1.401-1(a)(2)(i), (b)(1)(i) (as amended in 1976).

30 This beginning date is often referred to as the plan's "normal retirement age."

31 The benefit formula is stated in the defined benefit plan document. For example, a benefit formula might provide that a participant will accrue a pension benefit of 1% of the participant's final average compensation for each year of service with the sponsoring employer; as applied to a participant who was credited with 30 years of service, upon retirement, that participant would be entitled to a pension of 30% of

of any specified date, it is possible to compute the amount of defined benefit that each participant has earned through that date, based upon her years of service and compensation history through that date. This earned benefit is referred to as the "accrued benefit."[32] The defined benefit plan takes its name from the fact that it defines the retirement benefits that will be paid to participating employees. An employer that sponsors a defined benefit plan is obligated by the minimum funding requirements of ERISA and the Code to pay contributions to the retirement trust that will be sufficient to pay the benefits that the plan has promised to its participants.[33]

C. *Choosing Retirement Benefits*

The establishment of a retirement plan, the selection of the type and level of benefits, and (to some extent) the choice of the group of employees to participate in the plan are voluntary choices.[34] Many factors may influence an employer and its employees to choose retirement benefits as part of the employees' compensation. Among these factors are favorable legal treatment of retirement benefits by federal law. The Code confers special favorable income tax treatment on retirement benefits, and ERISA provides special legal protections to retirement plans and their participants. Business and personnel management factors can also weigh heavily in the choice. Where the

---

her final average compensation. If the participant's annual compensation for each of her last five years of employment averaged $40,000, then the participant would be entitled to a pension of $12,000.

32 *See* I.R.C. § 411(a)(7) (1994 & Supp. III 1997); ERISA § 3(23)(A), 29 U.S.C. § 1002(23)(A) (1994). Note that the accrued benefit is defined as a benefit beginning at the normal retirement age. Assuming that the participant has not attained the normal retirement age, the present value of the accrued benefit as of the date of computation would be the discounted present value of the accrued benefit that is projected to begin at normal retirement age. *See id.*

33 *See* I.R.C. § 412 (1994 & Supp. III 1997); ERISA §§ 301–08, 29 U.S.C. §§ 1081–86 (1994 & Supp. III 1997). In a defined benefit plan the sum of all accrued benefits for all participants represents the amount of retirement benefits which the plan has promised to pay; these accrued benefits are referred to as the "plan's liabilities." Retirement plan law includes mandatory minimum funding rules which obligate the sponsoring employer to pay annual minimum contributions to a pension trust so that the plan should have sufficient assets to meet the plan's liabilities as they become due. The minimum funding requirements apply to defined benefit plans and money purchase pension plans. A pension plan is necessarily a funded plan. *See id. See generally* 1 CANAN, *supra* note 23, §§ 12.1–.9; PERDUE, *supra* note 23, ¶¶ 13.08–.15.

34 The choice of the group of employees to participate in a retirement plan is constrained by the nondiscrimination rules. *See infra* note 205 and accompanying text.

balance of these factors offers an economic advantage to an employer and its employees, then the employer's compensation arrangements are likely to include retirement benefits as a part of employees' compensation packages. Conversely, if there is little or no economic advantage to be drawn from the establishment or continuation of a retirement plan, it is unlikely that retirement benefits will be provided.

1. Special Income Tax Treatment of Retirement Benefits

The Code creates a special income tax regime for "tax-qualified" retirement plans.[35] A sponsoring employer is allowed an income tax deduction for contributions paid to a retirement trust.[36] A participant in the plan does not recognize income as she earns increasingly valuable vested rights to receive retirement benefits.[37] The investment income of the retirement trust is exempt from current income

35 *See* I.R.C. §§ 401–20 (1994 & Supp. III 1997). Special favorable income tax treatment is extended to those retirement plans that satisfy the substantive standards set out for "tax-qualified retirement plans." In order to achieve "tax qualification," a plan must satisfy extensive statutory conditions; it must provide retirement benefits to a classification of employees that does not discriminate in favor of highly compensated employees, and the benefits must be provided on terms that Congress has defined as being worthy of receipt of the income tax incentive. Much of the legal regulation of retirement plans is expressed in the income tax requirements for qualification. When this Article refers to the "Code" as governing retirement plans, the reference is to I.R.C. §§ 401–20.

Tax qualification is a system of indirect regulation of a retirement plan; the Code specifies standards for the substantive content of a retirement plan document. In order to achieve tax qualification an employer must design its retirement plan document to satisfy these standards and operate the plan in accordance with this document. The Code's tax incentive evokes the appropriate content for a retirement plan, and then the retirement plan provides retirement benefits to employees on terms that Congress has deemed worthy of the tax subsidy. For example, the Code provides that a retirement trust will not be a "qualified trust" unless the trust provides full vesting for a participant no later than her seventh year of service. *See* I.R.C. § 411(a)(2)(B) (1994). If an employer desires to provide retirement benefits to its employees on a tax-qualified basis, the employer will cause the governing retirement plan document to provide participants with vested rights according to a schedule that satisfies the Code's standard. Since the retirement plan provides benefits in accordance with the Code's standards, the plan and its participants qualify for the special tax treatment allowed to tax-qualified retirement plans.

In addition, many of the Code's qualification standards are repeated as mandatory rules by ERISA. *See, e.g.*, ERISA § 203, 29 U.S.C. § 1053 (1994 & Supp. III 1997).

36 *See* I.R.C. § 404(a) (1994).

37 *See id.* § 402(a) (1994); Treas. Reg. § 1.402(a)-1(a)(1)(i) (amended 1994).

taxation.[38] Only when the retirement trust ultimately distributes assets to a participant as retirement benefits does the participant include the value of the distribution in her gross income.[39] The effect of these rules is to defer income taxation of savings held for retirement purposes until the savings are distributed from the retirement trust. This income tax deferral can continue over a substantial period; for example, if a participant were twenty-five years old when her employer made a contribution which funded her benefit, and she received a distribution upon retirement at age sixty-five, payment of income tax on the retirement benefits portion of her compensation, and the investment earnings on that contribution, would have been deferred for forty years.[40] This deferral of income taxation creates a tax incentive for compensation to be paid in the form of tax-qualified retirement benefits.[41] This special income tax treatment is a tax

38 *See* I.R.C. § 501(a) (1994).

39 *See id.* § 402(a); Treas. Reg. § 1.402(a)-1(a)(1)(i).

40 Although it is counterintuitive, the tax incentive is *not* the mere mismatch of the employer's deduction and the employee's recognition of income; this mismatch would create no tax advantage *if* the employer and the employee faced equal marginal tax rates at all times during the accumulation and distribution phases of the retirement plan *and if* the earnings of the retirement trust were taxed when earned at that same rate. *See* Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 YALE L.J. 506, 522–24 (1986). In practice, however, the marginal tax rates of the parties typically are not equal, and usually an employee's marginal rate after retirement will be lower than her rate during many of her years of active employment. And the Code explicitly exempts the investment earnings of the retirement trust from current taxation. Given these facts, savings held by a retirement trust enjoy a substantial tax advantage over savings that a taxpayer accumulates on an after-tax basis. Professor Stein offers an example in which saving through a retirement trust permits an employee to accumulate a retirement fund 2.5 times larger than that which would have been accumulated through regular savings. *See* Stein, *supra* note 22, at 230.

41 The deferral of income tax on amounts held to pay retirement benefits is generally described as preferential. *See, e.g.*, Stein, *supra* note 22, at 229–31. The preferential description is accurate if the baseline for comparison is the Schanz-Haig-Simons (SHS) income tax base. "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question." HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938). For a brief introduction to the SHS income tax base, see J. Clifton Fleming, Jr., *The Deceptively Disparate Treatment of Business and Investment Interest Expense Under a Cash-Flow Consumption Tax and a Schanz-Haig-Simons Income Tax*, 3 FLA. TAX. REV. 544 (1997).

Under the SHS formulation, an increase in savings is currently included in the income tax base. Retirement plans are funded, and that funding, and the investment earnings accumulated on that funding, represent savings—savings held for the particular purpose of paying retirement benefits to the employee-participants in the retirement plan. If one conceives of the retirement plan funding as savings of the sponsoring employer, held to pay deferred compensation in the form of retirement subsidy that enhances retirement plan sponsorship and participation.[42]

---

benefits to its employees, then the savings would be included in the employer's income tax base. If one conceives of the funding as compensation which the employees have accumulated during their employment and which is held to support them after retirement, then the savings would be included in the employees' gross incomes. Or one might choose to divide the income tax liability between the employer and employees, perhaps concluding that the retirement plan savings are properly attributable to the employer until an employee acquires vested rights to receive retirement benefits, at which time the savings are to be attributed to the employee for income tax purposes. Under the SHS formulation, the employer's deduction and an employee's income would be matched as a matter of timing, and the investment earnings accumulated on retirement savings would be included in some taxpayer's income tax base as those earnings were accumulated. The SHS tax base includes savings in the income tax base. When the employer is allowed a deduction for contributions to a retirement plan, those retirement savings are removed from the employer's tax base; in order to include the savings in some taxpayer's tax base in that year, the employee's income recognition must be matched with the employer's deduction.

Professor Zelinsky has challenged the conventional wisdom that the current tax treatment of retirement plans should be understood as preferential. He argues that a normative income tax system can reasonably include the present treatment of retirement plans. *See* Edward A. Zelinsky, *Qualified Plans and Identifying Tax Expenditures: A Rejoinder to Professor Stein,* 9 AM. J. TAX POL'Y 257 (1991) [hereinafter Zelinsky, *Qualified Plans*]; Edward A. Zelinsky, *Tax Policy v. Revenue Policy: Qualified Plans, Tax Expenditures, and the Flat, Plan Level Tax,* 13 VA. TAX REV. 591, 598–602 (1994) [hereinafter Zelinsky, *Tax Policy*]; Edward A. Zelinsky, *The Tax Treatment of Qualified Plans: A Classic Defense of the Status Quo,* 66 N.C. L. REV. 315 (1988) [hereinafter Zelinsky, *Tax Treatment*].

42 The tax subsidy increases the number of retirement plans over the number that would exist in its absence. *See generally* LANGBEIN & WOLK, *supra* note 13, at 30. The fact that retirement plans enjoy a tax subsidy is generally accepted as a justification for substantive regulation of the plans. *See generally* Daniel I. Halperin, *Special Tax Treatment for Employer-Based Retirement Programs: Is It "Still" Viable as a Means of Increasing Retirement Income? Should It Continue?,* 49 TAX L. REV. 1 (1993). For a justification of regulation of the vesting provisions of retirement plans, see WIRTZ REPORT, *supra* note 11, at 42. This analysis is not primarily concerned with the justification of mandated vesting on this ground. Instead, this analysis essentially assumes a constant level of tax subsidy and that the number of retirement plans and the level of benefits that they provide is consistent with that level of tax subsidy. The analysis then demonstrates the effects of a newly imposed legal mandate requiring more accelerated vesting. Among those effects will be a reduction in the number of retirement plans, and a reduction in the benefit levels provided by the remaining plans.

In reality over time, the amount of tax subsidy available to the retirement plan system in general changes constantly and mainly depends upon the marginal rates of individual income tax applicable to participants in retirement plans. *See* Halperin, *supra,* at 15–22. The amount of tax subsidy that any particular retirement plan will attract depends upon the marginal tax rates of participants in the plan.

The special income tax treatment of retirement plans is justified by the public policy to enhance retirement benefits. *See* STANLEY S. SURREY, PATHWAYS TO TAX RE-

The delivery of the subsidy for retirement plan sponsorship through the mechanism of income tax deferral has a collateral consequence of great significance. The tax incentive to pay compensation to an employee in the form of tax-deferred retirement benefits becomes greater as the employee's marginal tax rate increases.[43] An employee who faces a higher marginal tax rate will avoid a larger amount of income tax when she receives compensation in the form of retirement benefits than an employee in a lower tax bracket. In general and on average, highly compensated employees will be subject to higher tax rates than employees who are not so highly compensated.[44]

FORM 127 (1973) ("[T]he preferential tax treatment of qualified pension plans was intended to foster broad pension plan coverage . . . ."). "The basic justification for the indirect public subsidy involved in favored tax treatment lies in the social purposes served by private pension plans." WIRTZ REPORT, *supra* note 11, at viii.

Compare the conclusions of the Congressional Research Service:

> The earnings of stock-bonus or profit-sharing plans were exempted in 1921 and the treatment was extended to pension trusts in 1926.
>
> Like many early provisions, the rationale for these early decisions was not clear. . . . It seems likely that the exemptions may have been adopted in part to deal with technical problems of assigning income.
>
> . . . .
>
> . . . [Today] [t]he major economic justification for the favorable tax treatment of pension plans is that they are argued to increase savings and increase retirement security. The effects of these plans on savings and overall retirement income are, however, subject to some uncertainty.

CONG. RES. SERV., TAX EXPENDITURES 480–81 (S. Print No. 103-101 1994).

Professor Halperin has described the purpose of the tax subsidy much more narrowly: "[T]ax incentives traditionally have been provided to encourage employers to offer retirement protection for rank and file employees." Halperin, *supra*, at 7. The employees who are described as "rank and file" are essentially the same category that is referred to in this article as "non-highly compensated employees." *See infra* notes 227–29 and accompanying text. The extent to which the tax subsidy enhances retirement benefits for non-highly compensated employees depends upon the efficacy of the nondiscrimination rules. *See infra* note 210 and accompanying text.

43 *See* I.R.C. § 1 (1994). The deferral of income taxation will reduce an employee's tax liability as compared with the amounts that would have been payable if retirement benefits were taxed currently. However, highly compensated employees will enjoy greater tax savings than non-highly compensated employees. *See* Stein, *supra* note 22, at 231. Therefore, in general, highly compensated employees will have a stronger preference for retirement benefits, and non-highly compensated employees will have a stronger preference for wages. This implies that an employer with a larger proportion of highly compensated employees will be more likely to create a retirement plan for those employees than an employer that mainly employs non-highly compensated employees.

44 "Highly compensated employees" and "non-highly compensated employees" are both defined terms of art in retirement plan law. *See infra* notes 227–29 and accompanying text.

Therefore, the structure of the tax subsidy for retirement plans creates a pervasive pressure for a retirement plan to provide disproportionately larger retirement benefits to highly compensated employees.[45]

Apart from the income tax incentive for a retirement plan to favor highly compensated employees in its benefit structure, these employees are likely to have a stronger preference for retirement benefits. Retirement benefits are a form of savings, and highly compensated employees are more likely to have the economic resources for saving and perhaps higher than average propensities to save.[46]

The bias in favor of highly compensated employees is limited by an important component of retirement plan law, the Code's nondiscrimination regime.[47] The nondiscrimination regime attempts to require a retirement plan to provide reasonably comparable benefits to non-highly compensated employees, but these rules do not operate in

---

For a recent summary of effective marginal income and social security tax rates on earned income, see Elliott Manning & Laurence M. Andress, *The 1996 Marginal Federal Income Tax Rates: The Image and the Reality*, 73 TAX NOTES 1585 (1996). The combined marginal rates exceed 46% for a married couple both of whom are earners. *See id.* at 1597. In addition, the employer is subject to social security taxes that could push the combined tax burden above 50%. *See id.*

45 The amount of tax subsidy available to any particular retirement plan depends upon the proportion of highly and non-highly compensated employees who participate in the plan. The efficacy of a retirement plan as a tax deferral or avoidance device could be quantified by comparing the amount of taxes deferred in a given year with the amount of contributions to the plan and investment earnings of the trust fund in that year. A plan could be considered to be more "tax efficient" as it provided a greater ratio of tax deferral. A plan that provided benefits exclusively to participants who were highly compensated employees who faced high marginal tax rates would be more tax efficient than a plan that provided benefits to participants who faced lower tax rates. In a perverse effect, generally, as a plan covers more highly compensated employees, it becomes more tax efficient. *See* Joseph Bankman, *The Effect of Anti-Discrimination Provisions on Rank-and-File Compensation*, 72 WASH. U. L.Q. 597 (1994); *see also infra* note 210 and accompanying text.

Apart from the income tax incentive, highly compensated employees generally have a stronger preference for retirement benefits than non-highly compensated employees. From the perspective of a plan participant, retirement benefits are a form of personal savings. Individuals with higher incomes are able to save more than those with lower incomes. In fact, "[i]t is well established empirically that pension coverage is positively correlated with earnings levels and union status." David E. Bloom & Richard B. Freeman, *The Fall in Private Pension Coverage in the United States*, 82 AM. ECON. REV. 539, 540 (1992) (citations omitted).

46 *See infra* note 212 and accompanying text.

47 *See* Joseph Bankman, *Tax Policy and Retirement Income: Are Pension Plan Anti-Discrimination Provisions Desirable?*, 55 U. CHI. L. REV. 790 (1988).

any systematic manner to ensure that non-highly compensated employees generally receive retirement benefits.[48] The tension between a retirement plan's economic impulse to favor highly compensated employees and the effort of retirement plan law to channel retirement benefits to non-highly compensated employees is evident in much of the regulation of retirement plans.

2. ERISA's Special Legal Protections

ERISA provides special legal protections to retirement plans and participants. Plans are protected by the Act's broad federal preemption provision: ERISA "shall supersede any and all State laws insofar as they . . . relate to any employee benefit plan."[49] Early on, the Supreme Court gave full effect to this broad language, holding that ERISA preempted not only state law which conflicted with a substantive provision of the Act, but literally all state law that *relates* to an employee benefit plan.[50] This federal preemption implies that a retirement plan, the sponsoring employer, and their agents are not subject to state law claims most significantly tort claims.[51] Instead, these

48 *See infra* note 210 and accompanying text.

49 ERISA § 514(a), 29 U.S.C. § 1144(a) (1994). The term "employee benefit plan" clearly includes an employer-sponsored retirement plan. *See* ERISA § 3(2)–(3), 29 U.S.C. § 1002(2)–(3) (1994). For ERISA to apply, the sponsoring employer must be engaged in interstate commerce. *See* ERISA §§ 3(11), 4, 29 U.S.C. §§ 1002(11), 1003 (1994 & Supp. III 1997).

50 *See* Alessi v. Raybestos-Manhattan, Inc., 451 U.S. 504, 524–25 (1981). The purpose of this broad preemption has been succinctly stated: "A central objective of ERISA was to federalize pension and employee benefit law." LANGBEIN & WOLK, *supra* note 13, at 416; *see also* Boggs v. Boggs, 520 U.S. 833, 842 (1997) (referring to "ERISA's concern for securing national uniformity in the administration of employee benefit plans . . . ."). And this purpose has been realized: an employer-sponsored retirement plan is governed solely and exclusively by federal law.

The federalization of retirement plan law promotes the provision of retirement benefits in two ways. First, there is a single system of law governing retirement plans. One system of national law governing retirement benefits offers important simplification and administrative efficiencies to an employer that has employees in more than one state; the employer is assured that a uniform administrative and benefits structure will be legally permissible without regard to the place of residence of any of its employees. A single system of law also reduces the administrative costs associated with a retirement plan since the required expertise and systems are applicable on a nationwide basis. A single system of employee benefits law reduces the administrative costs and overhead associated with retirement plans.

51 In the absence of ERISA's preemption, the tort law of some states could subject an employee benefit plan or its administrator to liability for punitive damages. *See generally* LANGBEIN & WOLK, *supra* note 13, at 457–64. The possibility of potentially large punitive damage liability would introduce an important risk factor into the decision to sponsor a retirement plan.

actors are liable only to the extent provided by ERISA, and the Act provides limited legal remedies.[52] In general terms, a retirement plan is liable to plan participants only for the payment of benefits as provided by the plan, with some exposure for additional penalties.[53] ERISA effectively limits the liabilities of a retirement plan sponsor, thereby reducing the costs associated with a retirement plan and, hence, promoting retirement plan sponsorship.

ERISA also provides special legal protections to participants in a retirement plan. A plan or its associated trust must include a "spendthrift" provision, which protects a participant's retirement benefits against assignment or alienation.[54] Coupled with ERISA's preemption of state-law claims against a participant's retirement benefits, the spendthrift protection ensures that a participant's retirement benefits will not be subject to creditors' claims.[55] This special status enhances the value of compensation paid in the form of retirement benefits and thus promotes retirement plan participation and sponsorship.

3. Business Considerations

Apart from the special income tax and legal treatment of retirement benefits, both employers and employees may have preferences for compensation paid in the form of retirement benefits.[56] An employer may seek to increase employees' job tenures. Retirement plans and particularly defined benefit plans are associated with longer job tenures. Increased job tenure may allow an employer to provide more education and training for employees, since a longer job tenure will enable the employer to recover more of its training costs.[57] Not only may a plan increase job tenure so that employees remain employed through their most productive years, but the same plan may facilitate

---

52 *See* ERISA § 502(a), 29 U.S.C. § 1132(a) (1994 & Supp. III 1997). A participant may bring an action to compel compliance with ERISA, and for penalties in the case that a plan administrator fails to comply with its disclosure and reporting obligations. *See* ERISA § 502(c), 29 U.S.C. § 1132(c) (1994 & Supp. III 1997).

53 *See* ERISA § 502, 29 U.S.C. § 1132 (1994 & Supp. III 1997).

54 *See* ERISA § 206(d), 29 U.S.C. § 1056(d) (1994 & Supp. III 1997). Very similar requirements are imposed by the Code as conditions for plan qualification. *See* I.R.C. § 401(a)(13) (1994 & Supp. III 1997). The general rule forbidding assignment and alienation of retirement benefits is subject to several statutory and regulatory exceptions. *See, e.g.*, ERISA § 206(d)(2)–(3), 29 U.S.C. § 1056(d)(2)–(3).

55 *See* Patterson v. Shumate, 504 U.S. 753 (1992).

56 This second component of value is often referred to as the "nontax" reasons for employer sponsorship of a retirement plan. *See, e.g.*, LANGBEIN & WOLK, *supra* note 13, at 30–33; Halperin, *supra* note 42, at 8–11.

57 *See* RICHARD A. IPPOLITO, PENSION PLANS AND EMPLOYEE PERFORMANCE 27 (1997); *see also infra* note 70 and accompanying text.

a timely retirement of an older employee whose productivity might be declining.[58] A retirement plan may act as a sorting device, enabling an employer to select reliable and productive employees, while encouraging less valuable employees to leave the employer's workforce.[59] To generalize, a retirement plan can function as a compensation device that may enable an employer to assemble a more productive workforce.

From the perspectives of employees, compensation in the form of retirement benefits may be preferred to wage compensation. Some employees may distrust their ability to systematically save for retirement and, therefore, prefer that accumulations for their retirement years be structured for them through an employer-sponsored retirement plan.[60] Assets held by a retirement trust are often managed by a trustee with access to professional investment management services; generally, this arrangement may give employees the benefits of investment management which they could not acquire individually and which may provide superior rates of return. Finally, an employer-sponsored retirement plan may give employees access to annuity contracts at premiums calculated for a group of lives; these premiums may be more attractive than those charged for individual annuity contracts. In short, apart from the special income tax treatment of retirement benefits, some employees may prefer compensation in the form of retirement benefits instead of receiving the employer's cost of those retirement benefits as wage compensation.

D. Choosing a Retirement Plan

Income tax incentives, legal incentives, and business considerations all affect the choice by an employer and its employees to allocate a portion of compensation to the provision of retirement benefits. So long as a retirement plan can be designed to provide retirement benefits to employees who prefer those benefits to wages, the plan will be continued. A legally imposed restriction on the design of a retirement plan, such as mandated vesting, attempts to compel a plan to provide larger retirement benefits to some participants than those participants would have received in the absence of the mandate. If the employees who initially receive these mandated retirement benefits in fact prefer wages to the mandated benefits, the employees will be unwilling to accept the substitution of benefits for wages. Over

58 *See* IPPOLITO, *supra* note 57, at 41–60.

59 *See id.* at 79–156.

60 *See generally* Deborah M. Weiss, *Paternalistic Pension Policy: Psychological Evidence and Economic Theory*, 58 U. CHI. L. REV. 1275 (1991).

time the employees' preference for wages will control the composition of their compensation packages.[61] The level of retirement benefits provided to these employees must be reduced, or the retirement plan must be terminated.[62] Since the continuation or termination of a retirement plan is ultimately a voluntary choice, when a retirement plan no longer creates additional value for the sponsoring employer and the participating employees, the plan will be modified or terminated.[63] If the plan is terminated, then none of the employer's employees will receive employer-sponsored retirement benefits.[64] The

61 *See infra* notes 252–59 and accompanying text. This analysis is most applicable to an employer that operates in a competitive market for its products or services and faces a labor market in which there is competition for desired employees. *See infra* notes 252–59 and accompanying text.

62 The authority to adjust the level of contributions or to terminate a retirement plan is included in the authority to amend the plan, which, as a matter of form, is exercised by the employer. *See supra* note 15 and accompanying text. The essence of a profit-sharing plan is that the contributions may be varied from year to year; therefore, it is a simple matter for the employer to reduce the contribution level, even to zero. Contributions to a pension plan, including both a defined benefit plan and a money purchase pension plan, may be reduced or eliminated by an amendment to the plan, although only prospectively and after notice to the affected employees. *See* ERISA § 204(h)(1), 29 U.S.C. § 1054(h)(1) (1994). The reduction of future benefit accruals under a defined benefit plan does not affect the sponsoring employer's obligation to fully fund all accrued benefits. *See* ERISA §§ 301–08, 29 U.S.C. §§ 1081–86 (1994 & Supp. III 1997).

A retirement plan may be terminated at any time by an amendment to the plan that states that the plan is terminated or will be terminated at a future date. An amendment terminating a defined benefit plan is not effective until the Pension Benefit Guarantee Corporation has determined that the plan has sufficient assets to pay all accrued benefits. *See* ERISA § 4041, 29 U.S.C. § 1341 (1994).

63 Section 401(k) plans explicitly confer voluntary choice on participants as to the amounts which they will choose to save through the retirement plan. A § 401(k) plan is a particular species of profit-sharing plan that permits employees to make voluntary, pre-tax contributions of a part of their otherwise taxable compensation to the plan. *See* I.R.C. § 401(k) (1994). However, the retirement plan system allocates very few voluntary choices to employees, and those choices are typically of limited significance. Section 401(k) places numerous limitations on the amount of an employee's voluntary pre-tax contribution to her retirement plan, most notably a current maximum annual dollar limitation of $10,000 on contributions, and percentage limitations that depend upon the voluntary contributions made by non-highly compensated employees generally. *See id.* §§ 401(k)(2)–(3), 402(e)(3), (g) (1994). Professor Weiss argues that the paternalistic foundation of retirement benefits policy explains the very narrow range accorded individual employee choice in the retirement plan system. *See* Weiss, *supra* note 60, at 1282–83.

64 The power to amend the plan and to reduce or to eliminate retirement benefits may be exercised only prospectively. Benefits which have accrued through the date of the amendment may not be reduced. *See* I.R.C. § 411(d)(6) (1994); ERISA § 204(g)(1), 29 U.S.C. § 1054(g)(1) (1994). In furtherance of its nondiscrimination

right of an employer and its employees to opt out of the private retirement plan system acts as a pervasive constraint on the efficacy of mandatory regulation of retirement plans.[65]

II. Mandated Vesting

A. *The Vesting Problem*

A retirement plan creates a relationship among the sponsoring employer, the retirement trust fund, and the participating employee that may stretch across decades. If an employee began to participate in her employer's retirement plan at a young age, stayed with that employer for her entire working career, retired, and then received benefits from the plan during her entire retirement period, the relationship might exceed sixty years.[66] Since the relationship is potentially lengthy, it can involve many changes in circumstances; therefore, a retirement plan must address a wide variety of topics and contingencies. Obvious among these contingencies is the possibility, even

---

regime, the Code requires that all accrued benefits become fully vested upon a complete or partial termination, except that in the case of defined benefit plans this full vesting rule is limited to the extent that accrued benefits are funded. *See* I.R.C. § 411(d)(3) (1994). In furtherance of its employee protection purposes, ERISA requires advance notification to plan participants of future benefit reductions by plans which are subject to the minimum funding regime. *See* ERISA § 204(h), 29 U.S.C. § 1054(h) (1994).

65 "[T]he legislative and administrative burdens imposed during the Reagan-Bush years emerge as prime causes of diminished U.S. pension coverage—hence, the paradox that is federal retirement policy: discouraging the system of qualified plans in order to extend its benefits." Zelinsky, *Tax Policy*, *supra* note 41, at 597; *see also* Maria O'Brien Hylton & Lorraine A. Schmall, Cases and Materials on Employee Benefits Law 36 (1998).

> This dynamic—regulation followed by employer efforts to avoid or minimize the financial impact of the regulation—is crucial to bear in mind. The lesson might be that discretionary benefits can only be regulated up to a point. Once the cost becomes excessively expensive or the regulatory regime complicated, employers can (and do) opt out.

Id.

Recognition of the limits of mandatory regulation of a voluntary retirement plan system naturally leads to consideration of a mandatory employer-sponsored retirement plan system. A fully developed proposal for a Mandatory Universal Pension System (MUPS) was offered by President Carter's Commission on Pension Policy. *See* President's Comm'n on Pension Pol'y, Coming of Age: Toward a National Retirement Income Policy (1981). In the intervening years, concern about the availability of employer-provided health insurance has eclipsed efforts to expand retirement plan coverage. *See generally* Langbein & Wolk, *supra* note 13, at 38–41.

66 For example, if the participant began participation at age 25 and received retirement benefits until age 85, the relationship would last 60 years.

probability, that an employee will, prior to retirement, terminate her employment with the employer that sponsors the plan.[67] The vesting provision of a retirement plan specifies the level of benefits, if any, to be received by an employee who terminates employment prior to actual retirement. If a participant's rights in her retirement benefits are entirely unvested when she terminates employment, then she will forfeit all of her accrued retirement benefits, and she will receive nothing from the retirement plan with respect to her period of employment with that particular sponsoring employer.[68] If the participant's retirement benefits are fully vested upon employment termination,[69] she will receive some form of distribution from the plan. The present value of her retirement benefits might be paid to her shortly after termination, or she might receive retirement benefits at some future date, such as when she attains age sixty-five. The vesting provision of the retirement plan defines the moment or moments during a participant's career of service when she earns nonforfeitable rights to her retirement benefits.

1. Choices About Vesting

If vesting were unregulated, retirement plan design would consider several effects of deferred vesting. Deferral of vesting provides advantages to some employers and, perhaps surprisingly, to some employees. If an employer were strongly interested in binding certain of its employees to it for lengthy careers of service, then that employer might choose to defer vesting in whole or in part until an employee completed the desired career. The potential loss of retirement benefits that a plan participant would incur if she left employment would act as a substantial deterrent to quitting.[70] The risk of loss of retire-

67 The terminology "termination of employment" is used to include all cases of severance of the employment relationship between the employee and employer. The terminology includes a termination initiated by the employer ("firing") and a termination initiated by the employee ("quitting"). The terminology includes termination of employment without reference to whether the termination was "with cause" or "without cause." Generally, the vesting provisions of retirement plans do not differentiate levels of benefits based upon the circumstances of termination of employment.

68 *See* I.R.C. § 411(a)(2) (1994 & Supp. III 1997); ERISA § 203(a)(2), 29 U.S.C. § 1053(a)(2) (1994).

69 Alternatively, many retirement plans provide that a participant's retirement benefits become vested incrementally over a specified period of service; this is referred to as "graded vesting." *See generally* I.R.C. § 411(a)(2)(B); ERISA § 203(a)(2)(B), 29 U.S.C. § 1053(a)(2)(B); *infra* note 100.

70 Pensions are important tools to enforce long-term contracts in the firm. On average, they reduce quit rates by approximately 20% and increase tenure levels at older ages by over 25%. The results offer little support for the hypothesis that wage

ment benefits could also serve as a particular incentive for an older employee to continue to work diligently even as retirement approached.[71] These advantages appear to inure solely to the employer.

In fact, increased job tenures can benefit both employers and employees. When employers can bind new hires to longer careers of service, employers are more likely to invest in job-specific training for employees.[72] Greater investment in employee training will improve productivity and, depending upon the division of those gains between an employer and employees, raise both the employer's profits and the employee's wages.[73] Employers might generally support long-deferred vesting, or more accurately the availability of deferred vesting as a possible plan design element, because of the flexibility it allows in designing a retirement plan to achieve maximum value for both the sponsoring employer and the participating employees. Deferred vesting offers important and valid advantages in some retirement plan cases.[74]

---

tilt is an efficient substitute for pensions to deter quitting. *See* IPPOLITO, *supra* note 57, at 27.

71 This effect would limit "short-timer's syndrome," in which an employee who knows that she soon will be leaving a job relaxes her efforts. *Cf.* RICHARD A. POSNER, AGING AND OLD AGE 303–04 (1995).

72 Pension plans provide firms with a type of insurance against employees quiting prematurely by paying the firms

> a lump sum—the non-vested portion of payments—whenever a worker quits. Insurance is needed for specifically trained employees because their turnover would impose capital losses on firms. Firms . . . would be more willing to pay for training costs if insurance were provided. The effects on the incentive to invest in one's employees may have been a major stimulus to the development of pension plans with incomplete vesting.

GARY S. BECKER, HUMAN CAPITAL 48 (1993). "This economic function of incomplete vesting should caution one against conceding to the agitation for more liberal vesting privileges." *Id.* at 48 n.20.

73 Becker summarizes the division of both costs and gains of firm-specific training costs: "[Firms] share both with employees. The shares of each depend on the relations between quit rates and wages, layoff rates and profits, and on other factors not discussed here, such as the cost of funds, attitudes toward risk, and desires for liquidity." *Id.* at 44 (footnote omitted).

74 "Employer cost" of retirement benefits is not, in the long run, an important reason why an employer might prefer long-deferred vesting. It is true that an acceleration of vesting, whether by a voluntary change in a plan or in response to a legal mandate, increases the "cost" of a retirement plan in the sense that larger contributions must be made to the plan. Accelerated vesting is, in effect, a promise of larger benefits for employees. Larger benefits necessarily imply larger contributions to the plan. The employer is the nominal payer of plan contributions; however, over time, the cost of those contributions is shifted to the employees who benefit from the increased vesting. *See infra* text accompanying note 253. This cost shifting implies that

The disadvantage of long-deferred vesting is obvious: it imposes on the participant for a prolonged period the risk of forfeiture of her retirement benefits. From the perspective of a plan participant, when she accrues a benefit that is contingent upon completion of a fifteen year career of service, she should discount the value of that retirement benefit. Contingent retirement benefits are less valuable than vested benefits. Plan participants do not appear to be the only ones disadvantaged by deferred vesting. In fact, the discounted value of contingent retirement benefits is also a disadvantage for the sponsoring employer. Plan participants may discount the value of the benefit to a level below the cost of the benefit. In this case, a retirement plan is unlikely to continue to provide the participant with retirement benefits since the participant will be unwilling to accept the shifting of the costs of benefits to her.[75] Depending upon the preferences of a particular employer's workforce, deferred vesting could devalue retirement benefits so significantly that a retirement plan would not be acceptable to employees.

In a world without legal regulation of vesting, the choice of vesting periods in retirement plan design would balance the gains from increased job tenures with the devaluation of contingent retirement benefits. Different employers with different workforces would settle on different solutions for plan design.[76] There would be variation,

---

the additional benefits are either paid for by the employees who receive the benefits, or eliminated from the plan because those employees are unwilling to trade wages for the benefits. *See infra* note 252–59 and accompanying text. Therefore, in the long run, the "cost" of a retirement plan is not borne by an employer.

An employer, and more accurately, either the employer's owners or customers (if the employer has some market power in its product market), might bear the cost of the initial shock of a new vesting mandate. *See infra* note 253–54 and accompanying text. However, once employees' compensation packages and the retirement plan have been adjusted to the new vesting standards, the employer will not bear the cost of mandated vesting.

An employer might prefer to have the alternative of long-deferred vesting available as a retirement plan design element because it would enable a plan to provide retirement benefits only to those employees who prefer the benefits to wages. Deferred vesting is attractive to an employer because of the plan design flexibility it offers. To assert that mandated vesting is unattractive to an employer because of "cost" is misleading. The accurate explanation is that mandated vesting is unattractive because it causes a retirement plan to be unfeasible economically as a compensation device for some employers.

75 *See infra* notes 255–64 and accompanying text.

76 *Cf.* PETER J. WIEDENBECK & RUSSELL K. OSGOOD, CASES AND MATERIALS ON EMPLOYEE BENEFITS 544 (1996) ("Perhaps in some businesses, involving rapidly-changing technology, turn-over should be encouraged. And in others, like teaching school, stability may be especially valuable."). A related question is whether a business or

perhaps wide variation, in the degree of vesting offered. Some sponsoring employers would be more or less successful because of the plan design that they chose. Retirement plan design would evolve to provide the most valuable combinations of retirement benefits and deferred vesting.

2. Evolution of Vesting

During the early stages of development of the private retirement plan system, plans generally did not provide any vesting prior to retirement.[77] In 1875 the American Express Company started the first employer-sponsored retirement plan. By 1929 employer-sponsored plans covered fifteen percent of private employees, and by 1930 one-fifth of unionized workers were covered by union-sponsored pension plans.[78] Into the 1930s, few plans provided participants with vested rights.[79] Vesting, or more accurately its absence, was understood as a matter of contract law, and if a plan did not provide vested rights for participants, termination of employment would result in the loss of all retirement benefits. Courts evolved some common law doctrines that responded to difficult cases, but there was no general limitation on the principle of freedom of contract.[80]

By 1960 the private retirement plan system had expanded enormously; forty-one percent of U.S. workers were covered by some form

---

institution should make its own choices about turn-over and stability, or whether Congress should choose.

77 *See generally* Patricia E. Dilley, *The Evolution of Entitlement: Retirement Income and the Problem of Integrating Private Pensions and Social Security*, 30 LOY. L.A. L. REV. 1063, 1114–16 (1997); W.E. Shipley, Annotation, *Rights and Liabilities as Between Employer and Employee with Respect to General Pension or Retirement Plan*, 42 A.L.R.2d 461 (1955).

78 *See* CONG. BUDGET OFF., TAX POLICY FOR PENSIONS AND OTHER RETIREMENT SAVING 129–30 (1987).

79 *See id.* By the time that Murray W. Latimer made his encyclopedic study of private pension plans [1932], one out of every seven workers in industrial employment was covered by such a plan, but Latimer did not even mention the word "vesting" much less cite statistics as to its frequency. In various sections of his book, Latimer commented in a critical vein on the stringent requirements for benefit entitlement; but when, in the final pages of his lengthy work, he set forth the features of an ideal plan, he made no mention of vesting. It is known, however, that some plans of that era did provide for vesting of pension accruals prior to normal retirement age. *See* DAN M. MCGILL, PRESERVATION OF PENSION BENEFIT RIGHTS 102–03 (1972) (citing MURRAY W. LATIMER, INDUSTRIAL PENSION SYSTEMS IN THE UNITED STATES AND CANADA (1932)).

80 *See, e.g.*, Sigman v. Rudolph Wurlitzer Co., 11 N.E.2d 878 (Ohio 1937); Wilson v. Rudolph Wurlitzer Co., 194 N.E. 441 (Ohio App. 1934).

of retirement plan.[81] Retirement plans had also begun to voluntarily provide vested rights to participants.[82] At that time, two-thirds of all plans provided some degree of vesting for participants.[83] In addition to vesting that plans provided voluntarily, IRS policy increasingly demanded some degree of vesting. It had long been understood that, in order for a retirement plan to be tax-qualified, it ultimately must pay benefits to the participants.[84] By definition, payment of benefits implies vesting; after benefits are paid, the participant necessarily has vested rights in those benefits.[85] By the late 1960s, the IRS sometimes required some vesting in order to prevent certain plans, mainly those of small employers, from providing retirement benefits that were excessively discriminatory in favor of highly compensated employees.[86] However, within these broad limits, each retirement plan was free to determine its own conditions for vesting.

About twenty-five million employees were participating in private retirement plans at this time,[87] so it was inevitable that there would be cases in which a plan participant did not receive anticipated retirement benefits in questionable or controversial circumstances. Long-deferred vesting provisions insured that some long-service participants were denied retirement benefits. There were also cases of abuse of

81 *See* STUART DORSEY ET AL., PENSIONS AND PRODUCTIVITY 16 (1998); *see also infra* note 274 and accompanying text.

82 A common pre-ERISA retirement plan vesting schedule granted vested rights after the sum of the participant's age and years of service reached specified levels. For example, a participant would be fully vested when the sum of her age and years of service equaled or exceeded 65; therefore, a participant who was age 55 and had completed 10 years of service would be fully vested. This type of vesting rule rewarded long-tenure employees and provided retirement benefits to employees who were approaching a normal retirement age. The prevalence of these vesting schedules seems consistent with theories that employers sponsored retirement plans in order to encourage longer job tenures and to facilitate the retirement of older workers. Prior to ERISA, other common vesting rules were based upon age alone, or service alone, or some even deferred all vesting until actual retirement. Prior to vesting mandates, a wide variety of vesting rules had been adopted by different employers and different industries. *See* MCGILL, *supra* note 79, at 102–40. "[A] remarkable amount of vesting has already been provided [by 1972] on a voluntary basis, and the trend is expected to continue." *Id.* at 50.

83 *See* WIRTZ REPORT, *supra* note 11, at 38–39.

84 *See* Isidore Goodman, Speeches on Qualified Pension and Profit-Sharing Plans under the Internal Revenue Code between Oct. 20, 1955 and Oct. 5, 1970, Pens. & Profit Sharing (PH) ¶19,018, at 19,208–09 (Dec. 2, 1961).

85 *See id.* ¶19,018, at 19,205–06.

86 *See, e.g.*, Rev. Rul. 73-299, 1973-2 C.B. 137; Rev. Rul. 71-151, 1971-1 C.B. 123; Rev. Rul. 68-302, 1968-1 C.B. 163.

87 *See* WIRTZ REPORT, *supra* note 11, at 2.

retirement trusts and financial failure of plans.[88] In response to these concerns, in 1962 President Kennedy appointed a cabinet-level committee to review the legislation and administrative practices relating to private employee retirement plans.[89] The report of that Committee, commonly known as the *Wirtz Report*, was issued in 1965; it recommended extensive regulation of retirement plans, including mandated vesting legislation.[90] The *Wirtz Report* recommended that retirement plans be required to provide fifty percent vesting after fifteen years of service and an additional ten percent vesting for each of the next five years, so that full vesting would be achieved after twenty years.[91] Many of the *Wirtz Report's* recommendations were finally implemented with the enactment of ERISA in 1974.

ERISA brought a dramatic halt to the natural evolution of retirement plan vesting. The Act mandated that all retirement plans maintained by an employer engaged in interstate commerce provide participants with vested rights in their accrued retirement benefits.[92] The Act specified three alternative minimum vesting schedules and required a plan to satisfy at least one of the statutory schedules.[93] A plan had to provide vesting at least as rapidly as the statutory schedule, although a plan could provide more rapid vesting if it chose to.[94] In the years since ERISA's enactment, the federal vesting standards have been amended repeatedly, always in the direction of requiring additional vesting for participants after shorter periods of service.[95]

B. The Law of Mandated Vesting

Current retirement plan law mandates that a participant's retirement benefits vest upon the occurrence of any one of a variety of cir-

88 *See generally* LANGBEIN & WOLK, *supra* note 13, at 62–96.

89 The Committee was comprised of the Secretaries of Labor, Treasury, Health, Education and Welfare, and the Chairmen of the Council of Economic Advisers, the Board of Governors of the Federal Reserve System, and the Securities and Exchange Commission. *See* WIRTZ REPORT, *supra* note 11.

90 *See id.* at viii–xvi.

91 *See id.* at 42–44.

92 In general terms, ERISA covers an "employee benefit plan if it is established or maintained . . . by any employer engaged in commerce or in any industry or activity affecting commerce . . . ." ERISA § 4(a), 29 U.S.C. § 1003(a) (1994). "The term 'commerce' means trade, traffic, commerce, transportation, or communication between and State and any place outside thereof." ERISA § 3(11), 29 U.S.C. § 1002 (11) (1994).

93 *See* ERISA of 1974, Pub. L. No. 93-406, § 203(a)(2)(B), 88 Stat. 829, 854–55 (1974).

94 *See* § 203(d), 88 Stat. at 862.

95 *See* CONG. BUDGET OFF., *supra* note 78, at 11.

cumstances. One rule requires that "[e]ach pension plan shall provide that an employee's right to his normal retirement benefit is nonforfeitable upon the attainment of normal retirement age."[96] Other rules demand that upon a participant's death, some part or all of her retirement benefits must vest, so that they will be paid to her successor.[97] Most significant to this analysis are the rules mandating that a retirement plan must grant a participant vested rights in her accrued benefit after she completes a certain period of employment with the sponsoring employer. The law offers several alternatives for design of the plan's vesting provisions; they must comply with either the "five-year cliff vesting" schedule, the "seven-year graded vesting" schedule, or provide 100% immediate vesting.[98] To satisfy five-year cliff vesting, a participant must become fully vested no later than upon the completion of her fifth year of service; prior to that time, no incremental vesting is required.[99] To comply with the seven-year graded

---

96 ERISA § 203(a), 29 U.S.C. § 1053(a) (1994 & Supp. III 1997). This mandate is repeated as a condition for tax qualification. *See* I.R.C. § 411(a) (1994 & Supp. III 1997). ERISA defines normal retirement age:

> The term "normal retirement age" means the earlier of—
> (A) the time a plan participant attains normal retirement age under the plan, or
> (B) the later of—
> (i) the time a plan participant attains age 65, or
> (ii) the 5th anniversary of the time a plan participant commenced participation in the plan.

ERISA § 3(24), 29 U.S.C. § 1002(24) (1994). The Code repeats this definition. *See* I.R.C. § 411(a)(8).

The use of the "normal retirement age" terminology in retirement plan law reflects the traditional retirement age of 65, which was a part of the context in which ERISA was enacted. *See generally* LANGBEIN & WOLK, *supra* note 13, at 375–78, 385–400.

The mandated vesting concept would be much more clearly reflected if the statutory language dropped the references to normal retirement age and simply stated that retirement benefits must vest upon the later of the participant's attaining age 65 or completing five years of participation.

97 In the case of a defined contribution plan, the successor acquires a fully vested right to receive the participant's account balance. In the case of a defined benefit plan, the joint and survivor rules determine the amount of benefit that must be paid to a successor who is a surviving spouse.

98 *See* I.R.C. §§ 410(a)(1)(B)(i), 411(a)(2) (1994); ERISA §§ 202(a)(1)(B)(i), 203(a)(2), 29 U.S.C. §§ 1052(a)(1)(B)(i), 1053(a)(2) (1994 & Supp. III 1997).

99 *See* ERISA § 203(a)(2), 29 U.S.C. § 1053(a)(2)(A). The Code repeats the requirement as a condition for tax qualification: "A plan satisfies the requirements of this subparagraph if an employee who has completed at least 5 years of service has a nonforfeitable right to 100 percent of the employee's accrued benefit derived from employer contributions." I.R.C. § 411(a)(2)(A).

vesting schedule, a plan must grant a participant vested rights incrementally, with full vesting no later than upon completion of her seventh year of service.[100] The five-year cliff vesting or seven-year graded vesting schedules may be utilized only if the retirement plan permits an employee to begin participation in the plan upon completion of an eligibility waiting period not longer than one year.[101] If the plan requires a new employee to complete an eligibility waiting period longer than one year, then any accrued benefit must be fully vested when the employee completes two years of service.[102] (An eligibility waiting period may not exceed two years in any case.[103]) All these rules set minimum standards that an employer's retirement plan must meet; a retirement plan may provide participants with more rapid vesting or larger vesting percentages than the mandated statutory floors.[104]

In addition to the vesting rules that apply to all qualified plans, there is an additional set of more rigorous vesting requirements that apply only to retirement plans that meet the definition of a "top-heavy plan," a plan that has accrued more than sixy percent of its benefits for "key employees."[105] A top-heavy plan must provide either three-year cliff vesting or six-year graded vesting.[106] Top-heavy plans must

100 *See* ERISA § 203(a)(2)(B), 29 U.S.C. § 1053(a)(2)(B). The Code repeats the requirement as a condition for tax qualification:

> A plan satisfies the requirements of this subparagraph if an employee has a nonforfeitable right to a percentage of the employee's accrued benefit derived from employer contributions determined under the following table:

Years of service:	The nonforfeitable percentage is:
3	20
4	40
5	60
6	80
7 or more	100

I.R.C. § 411(a)(2)(B).

101 *See* I.R.C. § 410(a)(1)(A) (1994); ERISA § 202(a)(1)(A), 29 U.S.C. § 1052(a)(1)(A) (1994); *see also infra* notes 186–87 and accompanying text.

102 *See* I.R.C. § 410(a)(1)(B)(i) (1994); ERISA § 202(a)(1)(B), 29 U.S.C. § 1052(a)(1)(B) (1994).

103 *See* ERISA § 202(a)(1)(B), 29 U.S.C. § 1052(a)(1)(B).

104 *See* ERISA § 203(d), 29 U.S.C. § 1053(d) (1994) ("A [retirement] plan may allow for non-forfeitable benefits after a lesser period and in greater amounts than are required by [statute].").

105 *See* I.R.C. § 416(g), (i) (1994 & Supp. III 1997). In general terms, a key employee is an owner of the employer, or an officer of the employer who earns a specified minimum amount of compensation. *See* § 416(i)(1). The top-heavy rules are solely a requirement for income tax qualification and are not repeated in ERISA.

106 *See id.* § 416(a)(1), (b) (1994).

also provide certain minimum levels of benefits to "non-key" employees.[107] The top-heavy vesting rules have the same effects on top-heavy plans that the general vesting rules have on all retirement plans; the analysis of mandated vesting applies with equal force to the general vesting rules and the top-heavy vesting rules.[108]

C. *Justifications for Mandated Vesting*

Congress has offered several intertwined threads of justification for the enactment of mandated vesting.[109] ERISA's legislative history explained that mandated vesting would extend retirement benefits to additional employees, that it would increase the benefits received by non-highly compensated employees, and that it would improve the security of retirement income by preventing inequitable forfeiture of benefits by long-serving employees.[110] The first two justifications of mandated vesting, that it will extend retirement benefits to additional employees and to non-highly compensated employees in particular, are the principal focus of this analysis, which ultimately concludes that mandated vesting will not have these effects.[111] Subsection 1 below begins to consider mandated vesting with a "static analysis" of its effects, which seems to show that mandated vesting would enhance short-tenure employees' retirement benefits. Subsection 2 begins a

---

107 *See id.* § 416(a)(2), (c) (1994).

108 Mandated vesting for top-heavy plans means compliance with the top-heavy vesting rules. In general, the top-heavy rules can be understood as additional nondiscrimination rules applicable only to plans that are primarily benefiting the owners and officers of the sponsoring employer. The nondiscrimination regime applicable to all retirement plans is discussed *infra* notes 204–45 and accompanying text.

109 Mandated graduated vesting "helps [employees] to accumulate adequate pensions over their entire working careers and tends to spread the cost of providing such pensions more equitably over the various employers for whom they have worked during these careers . . . ." S. REP. NO. 93-383, pt. II (1974), *reprinted in* 1974 U.S.C.C.A.N. 4890, 4906.

110 On one level, the justification of mandated vesting as an improvement to the security of retirement benefits is simply another version of the justification that mandated vesting will increase aggregate retirement benefits. Greater security of retirement benefits means fewer and smaller forfeitures, which would seem to imply larger aggregate retirement benefits. *But cf. infra* notes 264–84 and accompanying text. In other words, improved security might be a desirable public policy goal because it increases aggregate retirement benefits.

On another level, improved security of retirement benefits may be an independent justification of mandated vesting. Mandated vesting may be a form of employee-protective legislation justified by a conclusion that employees generally are unable to protect themselves against the risks posed by employer sponsored retirement benefits that are subject to lengthy periods of forfeitability.

111 *See infra* note 253 and accompanying text.

"dynamic analysis" of the secondary and unintended effects of the vesting mandate in our voluntary retirement plan system. This iteration of dynamic analysis seems to show that mandated vesting reallocates retirement benefits from long-tenure employees to short-tenure employees. Subsection 3 further develops the hypothesis that mandated vesting might reallocate retirement benefits; a final conclusion on this point must await full development of the subsequent analysis. Subsection 4 offers a brief summary of the argument that improvement of the security of retirement benefits justifies mandated vesting.

1. Increased Retirement Benefits: The Static View

ERISA includes a fairly detailed recitation of Congressional findings and declaration of policy.[112] One of the findings was that "many employees with long years of employment are losing anticipated retirement benefits owing to the lack of vesting provisions . . . ."[113] This explanation for the enactment of mandated vesting is expanded in the House and Senate Committee Reports:

> This legislation is concerned with improving the fairness and effectiveness of qualified retirement plans in their vital role of providing retirement income. In broad outline, the objective is to increase the number of individuals participating in employer-financed plans; to make sure to the greatest extent possible that those who do participate in such plans actually receive benefits and do not lose the benefits as a result of unduly restrictive forfeiture provisions or failure of the pension plan to accumulate and retain sufficient funds to meet its obligations; and to make the tax laws relating to qualified retirement plans fairer by providing greater equality of treatment under such plans for the different taxpayer groups concerned.[114]

In order for retirement plans to effectively provide retirement income to employees generally, more employees need to participate in retirement plans,[115] and those who do participate need to have vested rights to benefits.

> Coverage under a pension plan does not aid an individual if he later forfeits his right to his pension benefits upon voluntary or involun-

112 *See* ERISA § 2, 29 U.S.C. § 1001 (1994).

113 ERISA § 2(a), 29 U.S.C. § 1001.

114 H.R. Rep. No. 93-807, pt. II (1974), *reprinted in* 1974 U.S.C.C.A.N. 4670, 4676–77. The same language appears in Sen. Rep. No. 93-383, pt. II (1974), *reprinted in* 1974 U.S.C.C.A.N. 4890, 4898.

115 ERISA sought to bring additional employees into retirement plan participation by means of statutory participation requirements. Coupled with the nondiscrimination regime, retirement plan law attempts to mandate that non-highly compensated employees receive retirement benefits. *See infra* notes 245–50 and accompanying text.

> tary termination of employment. This is an important consideration in view of the fact that ours is a fairly mobile economy where employees tend to change jobs rather frequently, especially in their younger years. Moreover, the cyclical and technological nature of certain industries results in frequent layoffs over a work career for employees in those industries, as in aerospace and defense. The committee bill deals with this problem by requiring qualified pension plans to grant covered employees minimum vested rights to their pension after serving a specified number of years.[116]

This rationale assumes that mandated vesting will cause employees to receive larger retirement benefits.[117] The *Wirtz Report* is explicit about the connection between vesting and the extension of retirement benefits to additional workers:

> With vesting, the employer's contributions are made available to a higher proportion of his work force. By bringing pension benefits to additional workers with a rightful claim to benefits, vesting strengthens the private pension system and the security function it is expected to perform.[118]

In 1986, when Congress accelerated the times at which retirement benefits must vest, it focused particularly on classes of disadvantaged workers:

> Congress believed that prior law did not meet the needs of many workers who changed jobs frequently. In particular, women and minorities were disadvantaged by the prior-law rules because they tended to be more mobile, shorter service employees. In addition, lower-paid employees, in general, were more likely to be mobile and thus more likely to terminate employment before vesting in any accrued benefits. Accordingly, Congress believed that more rapid vesting would enhance the retirement income security of low[] and middle-income employees.[119]

---

116 *See* S. REP. NO. 93-383, pt. II (1974), *reprinted in* 1974 U.S.C.C.A.N. 4890, 4904–05.

117 And in fact, mandated vesting has resulted in a greater percentage of all workers having at least some vested interest in retirement benefits. "[Mandated vesting] regulations have contributed to a higher vesting rate. Sixty perscent of active participants were fully vested by 1993, compared with 36 percent in 1975." DORSEY ET AL., *supra* note 81, at 17 (citaition omitted). This increase in the proportion of participants who are vested has coincided with the stagnation in coverage—that is, a decline in the proportion of employees who participate in a retirement plan. *See infra* notes 271–84 and accompanying text.

118 WIRTZ REPORT, *supra* note 11, at 40.

119 STAFF OF JOINT COMM. ON TAX'N, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 688 (Comm. Print 1987). The second reason given for acceleration of vesting was that employees may receive lower current money compensation when they also receive accruals of retirement benefits and that their accrued

Two important purposes of mandated vesting are to increase retirement benefits for existing plan participants and to extend retirement benefits to additional employees, particularly non-highly compensated employees.[120]

Initially it may appear that mandated vesting will necessarily have the effect of increasing retirement benefits. Mandated accelerated vesting implies that retirement plan participants who were less than fully vested, and who enjoy additional vesting under the mandate, will necessarily receive larger retirement benefits. Earlier vesting means fewer forfeitures, and fewer forfeitures mean more retirement benefits. A newly enacted vesting mandate unquestionably increases the retirement benefits to be received by (previously unvested) retirement plan participants to the extent that those benefits have accrued *at the time the mandate becomes effective.* This can be described as a static view of retirement plan benefits; a given amount of retirement benefits will accrue for plan participants, and if those participants have larger vesting percentages, then they will receive greater benefits.

There are two ways to measure a plan participant's retirement benefits: first, by the amount of the participant's accrued benefit, some or all of which might be vested; and second, by the value that

---

retirement benefits ought not be subject to long-deferred vesting. *Id.*; *cf. infra* note 159 and accompanying text.

Compare Congress's assertions about minority job tenures with the data: "The duration of employment among blacks is as long as that among whites. Even though jobs held by blacks are worse along almost every other dimension, they are no less stable than those held by whites." TURNER, *supra* note 10, at 17 (summarizing data from Robert E. Hall, *The Importance of Lifetime Jobs in the U.S. Economy*, 72 AM. ECON. REV. 716 (1982)).

Prior to 1986, the cliff vesting schedule required that a plan grant full vesting upon the completion of ten years of service. *See* I.R.C. § 411(a)(2)(A) (1985). The Tax Reform Act of 1986 amended the cliff vesting schedule to impose full vesting after five years of service. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 1113(a), 100 Stat. 2085, 2446–47 (1986). This amendment was effective for plan years beginning after December 31, 1988. *See* § 1113(c)(1), 100 Stat. at 2448.

120 Some commentators have explained mandated vesting as necessary to protect employees' interests in retirement benefits. *See, e.g.*, Peter J. Wiedenbeck, *Implementing ERISA: Of Policies and "Plans,"* 72 WASH. U. L.Q. 559, 571–76 (1994). From this perspective, mandated vesting is akin to consumer protection legislation; it protects employees from a risk (unanticipated forfeiture of retirement benefits) that employees are unable to protect themselves against. *See generally infra* notes 153–71 and accompanying text.

However, the question remains why it is appropriate policy to protect employees against forfeiture of retirement benefits. Presumably increasing retirement benefits (for those who are protected against unanticipated forfeiture) is a desireable goal in itself. Beyond this, it is not clear that there is an independent justification for restriction of forfeiture.

the participant assigns to her accrued benefit. Consider the measurement of the amount of a participant's vested accrued benefit. For example, under a defined contribution plan a participant with nine years of service might have an accrued benefit of, say, $50,000, but under a ten-year cliff vesting schedule, the participant would have no vested rights. In this case, the amount of her vested accrued benefit is $0, and if she terminates employment prior to completion of her tenth year of service, she will receive no retirement benefits. Suppose that after a new vesting mandate was enacted, this plan decided to comply by adopting a five-year cliff vesting schedule.[121] As of the effective date of the plan amendment, the amount of this participant's vested accrued benefit would instantly increase to $50,000.[122] If the participant terminates employment at any time after completion of five years of service, she will receive retirement benefits. The vesting mandate has conferred a one-time gain on the participant who had an unvested accrued benefit as of the effective date of the mandate, and that one-time gain implies that this participant will receive retirement benefits as a result of the mandate.[123] In these cases, mandated vesting has extended retirement benefits to a participant who would not have received any in the absence of the mandate.

Retirement plan participants who receive a larger vesting percentage solely because of mandated vesting will be referred to as "short-tenure employees." Other participants who had partial or full vesting under the plan's pre-mandate design, to the extent of their pre-ex-

121 In the above example, during the years five through nine, the mandate causes each participant to be 100% vested, as compared with 0% vested prior to the mandate. The benefits that are vested because of this mandate are referred to as "mandated benefits." Those participants in a retirement plan who have periods of service that fall within the mandated period as of the effective date of the vesting mandate will have an increase in the value of their retirement benefits at that effective date.

122 Mandated vesting increases the vesting percentages of participants only to the extent that the mandated vesting percentages exceed the vesting that the plan provided prior to the mandate. Before the enactment of mandated vesting standards, most retirement plans provided some level of vesting for participants in retirement plans. To the extent that mandated vesting exceeded these voluntary vesting levels, the vesting mandate caused some previously unvested participants to have vested benefits, and it caused an increase in the vesting levels of other participants. The comparison is not between mandated vesting and no vesting; the comparison is between mandated vesting and the vesting that would be provided by voluntary retirement plan design.

123 In the case of acceleration of a graded vesting schedule in response to a mandate, some participants will receive larger retirement benefits than they would have received in the absence of the mandate. When a new vesting mandate requires the acceleration of vesting under a graded vesting schedule, similar effects occur to the extent of the newly mandated increments of vesting.

isting vesting, will be referred to as "long-tenure employees."[124] Focusing upon retirement plan participants who had accrued some retirement benefit as of the effective date of a vesting mandate, the effect of mandated vesting is to provide additional retirement benefits to short-tenure employees, while having no effect upon the *vesting percentages* of long-tenure employees.[125] The retirement benefit that a short-tenure employee receives because of the mandated increase in her vesting percentage is referred to as a "mandated benefit"; in the example above, the $50,000 is a mandated benefit during years six through ten, because she is vested during that period solely because of the vesting mandate.

A second measure of retirement benefits is the *value* that a participant might place upon her accrued retirement benefits, even if those benefits are partly or fully forfeitable. For example, under a cliff vesting schedule, so long as a participant is unvested, the value of her accrued retirement benefits is discounted by a factor that reflects the risk that she might forfeit the benefits upon termination of employment. If a participant were subject to a ten-year cliff vesting schedule, and after nine years of service her accrued benefit were $50,000, she might conclude that there was a ten percent risk that she would forfeit the accrued benefit, so that she would value her accrued benefit at $45,000. When vesting is achieved, that risk of forfeiture is eliminated, and the value of her retirement benefits increases as of that moment.[126] Under a ten-year cliff vesting schedule, each participant enjoyed the increment in value arising from the elimination of the

124 Under these definitions, a single participant can be both a long-tenure employee and a short-tenure employee. For example, when graded vesting was accelerated from 15 years to seven years, a participant with seven years of service jumped from 35% vesting to 100% vesting. Under the definitions, this participant is a long-tenure employee with respect to her 35% vested percentage and a short-tenure employee with respect to the 65% vesting increment attributable to the vesting mandate.

125 The definitions isolate all effects of mandated vesting with the group of short-tenure employees. Long-tenure employees enjoy no increase in their vesting percentages. For example, when 10 year cliff vesting was accelerated to five-year cliff vesting, participants with 11 years of service did not have an increased vested percentage.

126 Yet another understanding of vesting would suggest that the risk of forfeiture discount under a five-year cliff vesting schedule diminishes incrementally as the participant completes each year (or hour) of service toward satisfaction of the five-year requirement. However, regardless of one's understanding of the shape of accrual of the vesting percentages over the fully or partially unvested portion of a participant's career, there is some discontinuous increment of value of retirement benefits when that last hour of service necessary for full (or graded partial) vesting is completed.

The absolute amount of the increment of value is larger the longer that vesting is deferred, since the risk of forfeiture applies to the entire retirement benefit and the accrued benefit is larger with increasing periods of service.

risk of forfeiture upon completion of her tenth year of service. After five-year cliff vesting was mandated, that incremental increase in value occurs upon completion of a participant's fifth year of service.[127] Focusing upon the value that a participant might assign to her unvested retirement benefits, the effect of mandated vesting is to accelerate the moment(s) in an employee's career when she receives the increment(s) of value of retirement benefits attributable to the elimination or reduction of the risk of forfeiture.

From the perspective of the value of retirement benefits, mandated vesting appears to confer value upon all of an employer's employees who are eligible to become participants in the employer's retirement plan. The acceleration of the moment when the risk of forfeiture is eliminated confers a one-time gain on a participant who has an accrued (but not fully vested) benefit at the time a vesting mandate becomes effective. This one-time gain in value is simply the participant's perception of the one-time increase in the amount of the participant's vested accrued benefit that was described above. For an employee who had not yet become a participant in the plan at the time the vesting mandate is effective, acceleration of vesting implies that, when the employee does become a participant and first accrues a benefit, the value of that benefit will be greater because the risk of forfeiture will be eliminated sooner. The earlier elimination of the risk of forfeiture appears to confer additional value on all short-tenure employees, both those participating at the time the mandate becomes effective, and those who enter the plan later.

From both of these perspectives, mandated vesting appears to increase retirement benefits for short-tenure employees. To the extent that a participant has an unvested accrued benefit, she enjoys a one-time gain equal to the amount that becomes vested. And even short-tenure employees who have not accrued benefits appear to enjoy a one-time gain in the expected value of the retirement benefits that they will accrue in the future, since mandated vesting reduces the risk of forfeiture of benefits. However, the focus on these one-time gains, the static view of mandated vesting, is seriously incomplete. The amount of retirement benefits that a retirement participant will receive depends not only on the participant's vesting percentage, but also on the total amount that the participant will accrue for retire-

127 In the above example, during the years five through nine, the mandate causes each participant to be 100% percent vested, as compared with 0% vesting prior to the mandate. Those participants in a retirement plan who have periods of service that fall within the mandated period as of the effective date of the vesting mandate will have an increase in the value of their retirement benefits at that effective date.

ment benefits. The next Section begins a dynamic analysis of how vesting mandates will affect the amounts of participants' accrued benefits.

2. Reallocation of Retirement Benefits Among Participants: Dynamic Analysis

Under static analysis, mandated vesting confers one-time gains on short-tenure employees by increasing their vesting percentages in their accrued benefits. The first step in a dynamic analysis of mandated vesting is to consider the effects of a vesting mandate on the retirement benefits of the employees who are not affected by the text of mandated vesting, that group of plan participants designated as long-tenure employees. An initial effect of mandated vesting is to reduce the total amount of forfeitures in a retirement plan;[128] this results from a reduction in the number of participants who forfeit their accrued retirement benefits in any given plan year, and from a reduction in the value of those forfeitures that do occur. For example, under ten-year cliff vesting some participants would forfeit accrued benefits upon termination of employment during their sixth through tenth years of service. And the value of forfeitures in these years would exceed the value of the accrued benefits at the end of the fifth year of service since a participant's accrued benefit increases in value as the period of service increases. When mandated vesting reduced the cliff vesting period from ten years to five years, fewer terminating participants forfeited their accrued benefits, and those who did forfeit their benefits forfeited a smaller amount. This reduction in forfeitures is equivalent to the increased retirement benefits that short-tenure employees receive; those benefits that are not forfeited are paid out as additional retirement benefits.

In a profit-sharing plan, the reduction in forfeitures by short-tenure employees has a direct effect upon the accrued benefits of long-tenure employees. A profit-sharing plan allocates forfeitures among those participants who continue active employment with the sponsoring employer; thus, forfeitures increase the accrued benefits of long-tenure employees.[129] When forfeitures are reduced, the initial, direct

---

128 The total amount of retirement benefits that are forfeited during a plan year are referred to as the "forfeitures."

129 Allocation of forfeitures in a profit-sharing plan is governed by a provision of the plan document. Traditionally many profit-sharing plans allocated forfeitures pro rata to participants' account balances as of the end of the plan year in which the forfeiture occurred. This allocation usually favored long-tenure employees since account balances are the cumulative sum of prior contributions and investment returns. *See* Sol Walker & Co. v. United States, 636 F.2d. 298 (Cl. Ct. 1980) (holding that an

effect is to reduce the benefit accruals of long-tenure employees to lesser amounts than they would have enjoyed in the absence of the mandate. A reduction in benefit accrual for a long-tenure employee implies that she will receive smaller retirement benefits. If the contributions to a profit-sharing plan are not increased to an amount sufficient to restore the accrual of benefits of long-tenure employees to their pre-mandate level, the vesting mandate appears to have simply reallocated retirement benefits from long-tenure employees to short-tenure employees.[130]

If a pension plan is providing retirement benefits, the effect of a reduction in forfeitures is less obvious. Forfeitures under a pension plan may not be used to increase these benefits, but instead are applied as credits against the employer's required contributions.[131] Thus, the initial, direct effect of a vesting mandate in a pension plan is to increase the amount of contributions that must be paid to the plan.[132] All of the mandated benefits are paid to short-tenure employees, so that all of these increased contributions fund benefits for short-

---

allocation pro rata with account balances is not inherently discriminatory). Rev. Rul. 81-10, 1981-1 C.B. 172 requires that an allocation of forfeitures must not result in the prohibited discrimination against non-highly compensated employees. An alternative allocation provision would allocate forfeitures pro rata with participants' compensation for the plan year in which the forfeiture occurred. Allocation pro rata with participants' compensation is nondiscriminatory.

130 Reallocation of retirement benefits in this manner might be a desirable outcome, if it were a stable arrangement. However, reallocation of retirement benefits will cause additional adjustments in the structure of retirement plan benefits. *See infra* notes 250–84 and accompanying text.

131 *See* Treas. Reg. § 1.401-1(b)(1)(i), -7 (1963). The employer that sponsors the plan is required to pay contributions sufficient to fund the benefits that the plan has promised to pay. *See supra* note 33.

132 The vesting mandate requires the payment of additional benefits, and the employer is obligated to make contributions to the plan sufficient to pay all benefits. Thus the cost of the plan increases. Professor McGill worked on studies that preceded the enactment of ERISA's first vesting mandates. He concluded,

> It should be apparent at this stage that only the most generalized statements can be made concerning the cost of vesting. Too many variables are involved to permit categorical or unqualified pronouncements in respect of the general cost impact. . . . [An] estimate may prove to be faulty not only because of the inherent volatility of turnover rates but also because the very act of adopting a vesting provision may alter the firm's pattern of employment terminations.

MCGILL, *supra* note 79, at 175–76.

Shortly after the enactment of ERISA's first vesting mandate, Professors Greenough and King reviewed some of the estimates of the increases in the cost of funding a defined benefit plan which might be caused by mandated vesting. These estimates ranged from immaterial cost increases to increases of up to 25% in plan funding cost.

tenure employees. Because a pension plan fixes the amount of benefit (or in the case of a money purchase pension plan, the amount of the contribution), mandated vesting appears to increase the benefits of short-tenure employees, with these benefits being paid for by increased employer contributions. And there appears to be no effect upon the retirement benefits of long-tenure employees.

After the initial shock of newly mandated accelerated vesting, an employer must consider whether to continue to pay an increased level of contributions, or to adjust the compensation packages of the short-tenure employees, or to adjust the level of retirement benefits to eliminate the incremental mandated benefits. Subsequent analysis develops the factors that control this decision; generally the level of benefits will be adjusted in order to return the level of contributions to that which existed prior to enactment of the mandate.[133] The level of benefits provided by a pension plan can be reduced prospectively; the plan can be amended to reduce the rate at which benefits accrue in the future.[134] Future benefit accruals can be reduced to a level that can be financed with the pre-mandate plan contributions. If this were done, short-tenure employees would receive increased retirement benefits, while long-tenure employees would receive reduced retirement benefits.[135] Assuming there is no increase in contributions, the

See William C. Greenough & Francis P. King, Pension Plans and Public Policy 169–72 (1976).

133 *See infra* notes 253–64 and accompanying text. The decrease in plan contributions precipitated by a vesting mandate will generally return the level of retirement benefits of short-tenure employees to that level which existed prior to the mandate, while causing an absolute decrease in the retirement benefits of long-tenure employees. The combined effect of mandated vesting and the nondiscrimination rules will be to cause pension plan contributions to be reduced to a level *below* that which existed prior to the vesting mandate. *See infra* notes 265–72 and accompanying text.

134 *See supra* note 62 and accompanying text. In the typical case, the plan will adopt a new benefit formula providing a new, reduced rate of accrual of benefits for all plan participants, both short-tenure employees and long-tenure employees. *See infra* notes 264–65 and accompanying text.

135 The reduced benefit level applies to all plan participants during all their future years of participation. This implies that, except for those short-tenure employees who receive retirement benefits solely because of the vesting mandate, all participants in a pension plan will ultimately receive smaller retirement benefits than they would have received prior to the vesting mandate. In the case of a defined benefit plan, the reduced future benefit level translates directly to lower benefits. The effect is the same in a money purchase pension plan. For example, assume that the money purchase pension plan specified that contributions were to be made to the plan equal to six percent of compensation and that, prior to an additional vesting mandate, forfeitures paid for three percentage points of this contribution. The employer would have had a net cost for its money purchase pension plan of three percent of compensation. Assume that after the vesting mandate, forfeitures paid only one percentage

second stage effect of mandated vesting on a pension plan is identical to the effect on a profit-sharing plan: retirement benefits are reallocated away from long-tenure employees and toward short-tenure employees.[136]

In both profit-sharing and pension plans, mandated vesting can lead to increased aggregate retirement benefits only if contributions to the plan are increased to cover the cost of the additional retirement benefits that short-tenure employees receive as a result of the mandate. Since contributions to a plan generally will not be increased over the long run in response to mandated vesting,[137] at this stage in the analysis, the effect of vesting mandates appears to be a reallocation of retirement benefits from long-tenure employees to short-tenure employees. A reallocation of retirement benefits implies that there is no increase in the aggregate retirement benefits of all plan participants.

The justification of mandated vesting predicated on increasing the amount of retirement benefits can now be more accurately stated as increasing the amount of retirement benefits of short-tenure employees, at the expense of the retirement benefits of long-tenure employees. Analysis below illustrates that our category of "short-tenure employees" will also include a disproportionately large fraction of an employer's "non-highly compensated employees."[138] The group of non-highly compensated employees will include low and middle-income employees. Thus the policy question becomes the desirability of reallocating retirement benefits from long-tenure employees to short-tenure employees, where the category of short-tenure employees in-

point of the contribution. To hold its net cost of the plan constant, the employer would have to reduce the future contribution rate to four percent of compensation. This results in a lower level of retirement benefits.

A reduction in the retirement benefits of long-tenure employees is not, in itself, a stable situation. If the retirement benefits of long-tenure employees are reduced, then the wage portion of their compensation packages must be increased to bring the value of their compensation to the level that existed prior to the vesting mandate. *See infra* notes 265–70 and accompanying text.

136 *See* Wolk, *supra* note 13, at 454 n.154 ("Shorter vesting would merely redistribute the benefits.").

137 *See infra* notes 252–64 and accompanying text.

138 "Non-highly compensated employees" is a defined term of art in retirement plan law. *See infra* notes 227–29 and accompanying text. "Non-highly compensated employees" are employees who are not "highly compensated employees," another defined term of art. As a working example, in many cases, non-highly compensated employees are those who earn less than $80,000 per year, and highly compensated employees earn more than that. *See infra* notes 229–31 and accompanying text.

cludes a disproportionate number of low and middle-income employees.

3. Is Reallocation Desirable?

Reallocation of retirement benefits might be desirable on two grounds. First, providing some retirement benefits to both short-tenure employees and long-tenure employees might be preferable to providing a higher level of benefits predominantly for long-tenure employees. Second, since short-tenure employees on average earn less compensation than long-tenure employees, reallocation of retirement benefits might be a means to redistribute income to lower income individuals, which could be judged to be a desirable outcome in itself.[139]

Justification of mandated vesting on grounds that it distributed retirement benefits more evenly across employees with different job tenures was relied upon by the *Wirtz Report*[140] and by Congress years later in 1986 when it accelerated cliff vesting from ten years to five years.[141] The *Wirtz Report* concluded,

> Nonetheless, if a choice must be made between a system that provides a higher level of benefits but only for those who remain with their employer until retirement age against one that assures a slightly lower level of benefits to all workers after a reasonable period of service, public policy clearly must choose the latter.[142]

The Wirtz Committee offered this conclusion as self-evident. Professor McGill prepared a definitive work on pension vesting in the years immediately following the release of the *Wirtz Report*,[143] and it more fully captures the nuances of the debates during that period.[144] McGill summarizes the competing arguments:

---

139 An important principle of retirement plan law is the nondiscrimination norm, the concept that a plan may not accrue retirement benefits in a way that discriminates excessively against non-highly compensated employees. *See infra* note 205 and accompanying text. In order for benefits that accrue on a nondiscriminatory basis to be actually paid to retired non-highly compensated employees, mandated vesting is a necessary element of the system. *See infra* note 248 and accompanying text. However, there is serious concern that the nondiscrimination regime operates in such an unsystematic fashion that it is ineffective to deliver retirement benefits to non-highly compensated employees generally. *See infra* note 210 and accompanying text. If the nondiscrimination regime is itself dubious, it cannot offer a sound justification for mandated vesting.

140 *See* WIRTZ REPORT, *supra* note 11, at 41.

141 *See supra* note 119 and accompanying text.

142 WIRTZ REPORT, *supra* note 11, at 41.

143 *See* MCGILL, *supra* note 79, at x.

144 *See id.* at 29–32.

> [O]ne of the [arguments] in favor of vesting is that it produces a more equitable distribution of benefits among the plan participants. Interestingly, one can argue against vesting on the same grounds. In its simplest form, the equity issue can be reduced to the question of whether, out of a given pension budget, it is more equitable to provide smaller (but more secure) benefits to a larger number of persons or larger (but more uncertain) benefits to a smaller number of persons. . . . Persons who take this [latter] position view pensions as a 'differential wage' for long and faithful service. They contend that long-service employees make a special contribution to the firm, not reflected in ordinary wage scales, which entitles them to preferential treatment at retirement.[145]

McGill offers no clear recommendation about mandated vesting, other than to summarize the conclusions and reasons offered by the Wirtz Committee. These arguments offer no compelling logical reason to conclude that retirement benefits ought to be distributed more or less evenly across employees, nor any explanation of why that distribution is a proper object for federal legislation. If vesting had been left unregulated, some retirement plans would choose to concentrate retirement benefits on long-tenure employees; other retirement plans would provide retirement benefits to a broader group of employees. The question remains why a uniform legal solution is to be preferred to the many differing solutions that individual employers and their particular workforces would settle upon.

Perhaps the appeal of a more even distribution of retirement benefits across the workforce lies in the second justification, that redistribution of retirement benefits might be perceived as largely equivalent to redistribution of income from more privileged to less privileged workers. The distribution of income that results from the U.S. economic system has long been the source of widespread dissatisfaction, and various public policies to adjust that distribution enjoy deep and long-term support.[146] If mandated vesting were likely to re-

---

145 *Id.* at 38–39. Note that McGill accepts as a fact the proposition that an employer faces a fixed budget for retirement benefits. This fact is an essential element of the dynamic analysis of mandated vesting, *see supra* note 17 and accompanying text, and an essential element of the analysis of this article, *see infra* note 253–57 and accompanying text.

146 In their classic analysis, *The Uneasy Case for Progressive Taxation*, Professors Blum and Kalven conclude,

> [I]n the end it is the implications about economic inequality which impart significance and permanence to the issue and institution of progression. Ultimately a serious interest in progression stems from the fact that a progressive tax is perhaps the cardinal instance of the democratic community struggling with its hardest problem.

allocate income in the form of retirement benefits to poorer workers, then it might be justified as desirable social policy on those grounds.

As an empirical matter, mandated vesting is misguided as income redistribution policy. Mandated vesting as an income redistribution device can only affect employees who participate in a retirement plan. About forty-three percent of the labor force participate in a retirement plan.[147] The participation is heavily skewed toward higher income workers.[148] About seventy-seven percent of workers earning more than $30,000 participate in a plan, while fewer than thirteen percent of workers earning less than $10,000 participate.[149] The retirement plan system mainly benefits the higher-earning half of the labor force. The technical definition that retirement plan law provides for the highly compensated employee group limits that group to approximately the most highly paid five percent of the of the total labor force.[150] If mandated vesting were effective as an income redistribution device (which it is not),[151] it would be redistributing income largely from the most highly paid five percent of the workforce to those in the fiftieth to ninety-fifth percentiles. Such redistribution

WALTER J. BLUM & HARRY KALVEN, JR., THE UNEASY CASE FOR PROGRESSIVE TAXATION 104 (1953).

For a recent summary of data suggesting an increasingly unequal distribution of income, and an argument that this unequal distribution of income justifies greater progressivity in the income tax rate structure, see Martin J. McMahon, Jr. & Alice G. Abreu, *Winner-Take-All Markets: Easing the Case for Progressive Taxation*, 4 FLA. TAX REV. 1 (1998). *See generally* Erwin Chemerinsky, *Making the Case for a Constitutional Right to Minimum Entitlements*, 44 MERCER L. REV. 525 (1993) (arguing that the U.S. Constitution should be interpreted to provide citizens with a right to basic subsistence).

147 *See infra* note 274 and accompanying text.

148 The data demonstrate that few of the lowest income workers participate in a plan, while 80% of those earning $50,000 or more do participate.

Retirement Plan Participation, 1993

Annual Earnings (1993 dollars)	Participation Rate (percentage)
Under $5000	3
$5000–9999	13
$10,000–14,999	29
$15,000–19,999	45
$20,000–24,999	61
$25,000–29,999	64
$30,000–49,999	75
$50,000 or more	80

MCDONNELL ET AL., *supra* note 5, at 91.

149 *See id.*

150 *See infra* note 232 and accompanying text.

151 *See infra* notes 254–66 and accompanying text.

would do little for the least privileged workers, and it cannot justify mandated vesting or the present structure of retirement plan law.

As a theoretical matter, mandated vesting cannot be an effective income redistribution mechanism. The ultimate explanation is the fact that the private retirement plan system is voluntary. This analysis will demonstrate that in our voluntary system, employers will adjust employees compensation packages, and retirement plans will adjust benefit levels, in order to eliminate any additional retirement benefits that are mandated by vesting mandates or by other aspects of retirement plan law. Mandated vesting will not increase the retirement benefits of short-tenure employees and non-highly compensated employees.[152] As a program for income redistribution, mandated vesting will prove futile. And mandated vesting is destructive of our voluntary system.[153] To justify mandated vesting, then, a purpose other than income redistribution must be found.

4. Protection of Employee Interests

Mandated vesting might be justified as necessary to provide an adequate level of protection of employee interests in retirement benefits. In other words, even granting that mandated vesting reduces the aggregate total of retirement benefits provided to employees, one might conclude that it is preferable to have a smaller quantity of the more secure retirement benefits that mandated vesting promises. This Subsection briefly reviews justifications for mandated vesting that are independent of its effects upon the aggregate amount of retirement benefits or the distribution of those benefits among employees.

The sponsorship of a retirement plan by an employer appears to create legal and financial relationships that are fraught with potential for disappointment of employees' expectations. A promise by a sponsoring employer and a retirement plan to pay retirement benefits is an executory promise with an unusually long performance period. As noted above, an employee might provide services as long as sixty-five years prior to complete performance of the promise of retirement benefits.[154] The lengthy performance period virtually ensures that there will be numerous changes in circumstances for the sponsoring employer, the retirement plan, and the employee. Much of ERISA can be understood as an effort to protect an employee from loss of

152 *See infra* note 253 and accompanying text.

153 *See infra* notes 264–83 and accompanying text.

154 *See supra* note 65 and accompanying text.

her retirement benefits during her potentially lengthy working career and retirement period.[155]

Mandated vesting limits one specific risk to an employee's retirement benefits, the risk that the benefits will be forfeited because the employee fails to complete a requisite period of service. Limitation of the risk of forfeiture by a long-serving employee appears to present a compelling case for governmental restriction on the freedom of contract. In a narrow sense, the forfeitability of a retirement plan participant's accrued benefits creates a conflict of interest for the sponsoring employer. By definition, long-deferred vesting extends the period during which retirement benefits are forfeitable and increases the amount of a potential forfeiture. In the case of a pension plan, forfeitures directly and immediately reduce the amount of contributions that the employer must pay to the trust. Since employment is generally an "at will" relationship between employer and employee,[156] an employer is in a position to reap an immediate economic benefit by terminating unvested pension plan participants. In the case of a profit-sharing plan, forfeitures directly increase the accrued benefits of long-tenure employees, who generally have stronger preferences for retirement benefits. By causing forfeitures of accrued profit-sharing benefits, an employer could indirectly capture economic benefit by allocating retirement benefits to those employees who value the benefits most highly. Long-deferred vesting appears to create a financial incentive for an employer to renege upon the promise of retirement benefits.

This risk—the risk of loss of retirement benefits—was cited by Congress in 1973 as a reason to mandate minimum levels of vesting in ERISA.

> Over two-thirds of the private retirement plans provide vested rights to retirement benefits before retirement. However, as a general rule, employees do not acquire vested rights until they have accumulated a fairly long period of service with the firm and/or are relatively mature.
>
> At present, only one of every three employees participating in employer-financed plans has a 50 percent or greater vested right to his accrued retirement benefits. Moreover, 58 percent of covered

155 *See* H.R. REP. No. 93-533, at 1 (1973), *reprinted in* 1974 U.S.C.C.A.N. 4639, 4639 ("The primary purpose of the bill [a precursor of ERISA] is the protection of individual pension rights, but the committee has been constrained to recognize the voluntary nature of private retirement plans."); LANGBEIN & WOLK, *supra* note 13, at 97 ("The central problem to which ERISA is addressed is the loss of pension benefits previously promised.").

156 *See* E. ALLEN FARNSWORTH, CONTRACTS 513 (3d ed. 1999).

> employees between the ages of fifty and sixty and 54 percent of covered employees sixty years of age and over do not have a qualified vested right to even 50 percent of their accrued retirement benefits. As a result, even employees with substantial periods of service may lose retirement benefits on separation from employment. Extreme cases have been noted in which employees have lost retirement rights at advanced ages as a result of being discharged shortly before they would be eligible to retire.[157]

Congress relied extensively on the conclusions of the *Wirtz Report* in its explanations for mandated vesting. The Report of the Senate Committee on Labor and Public Welfare simply quoted the Wirtz Committee's conclusion: "[T]he degree of retirement protection in private pension plans varies widely and in many cases remains quite inadequate."[158]

The *Wirtz Report* itself offers further explanation for mandated vesting:

> As a matter of equity and fair treatment, an employee covered by a pension plan is entitled, after a reasonable period of service, to protection of his future retirement benefit against any termination of his employment. Vesting validates the accepted concept that employer contributions to pension plans represent 'deferred compensation,' which the individual worker earns through service with his employer.
>
> Without vesting, a worker displaced after long years of service is denied all of his accrued pension protection. A worker in a similar position who voluntarily changes his employment has to forfeit his right to a future pension. Both circumstances are charged with inequity.[159]

One argument is premised on the "accepted concept" that an employer's contributions to a retirement plan represent deferred compensation that has been earned by the participants in the plan. This argument merely begs the question about mandated vesting of retirement benefits. Obviously retirement benefits are a form of deferred compensation.[160] But the question remains about the extent to which a retirement plan ought to be permitted to offer retirement benefits that are contingent upon an employee's completion of a specified period of service. Observing that retirement benefits are a form of deferred compensation does not advance understanding of reasons for mandated vesting.

157 H.R. REP. No. 93-807, at 12 (1973), *reprinted in* 1974 U.S.C.C.A.N. 4639, 4679.

158 S. REP. No. 93-127, at 8 (1973), *reprinted in* 1974 U.S.C.C.A.N. 4838, 4845.

159 WIRTZ REPORT, *supra* note 11, at 39.

160 *See supra* note 16 and accompanying text.

The other explanation developed in the *Wirtz Report* focuses upon the inequity of a long-term employee's forfeiture of accrued benefits. Cases involving such forfeitures evidence two types of characteristics, which can be labeled "abusive," and "innocent." The prototypical forfeiture evidencing abusive characteristics would result from an employer's purposeful termination of a faultless employee for the purpose of capturing the value of the employee's accrued benefits.[161] An example of a case evidencing innocent characteristics might be a termination of employment that results from the loss of an employer's place of business due to a natural disaster. Mandated vesting reduces the risks of loss by a plan participant from both sorts of forfeitures.

Forfeitures that clearly evidence abusive characteristics were specifically targeted by section 510 of ERISA:

> It shall be unlawful for any person to discharge, fine, suspend, expel, discipline, or discriminate against a participant or beneficiary for exercising any right to which he is entitled under the provisions of an employee benefit plan, . . . or for the purpose of interfering with the attainment of any right to which such participant may become entitled under the plan . . . .[162]

Under this provision, if a participant were able to prove that her employer terminated her employment for the purpose of causing a forfeiture of her retirement benefits, then she would be entitled to restoration of the benefits. As we consider whether the advantages of mandated vesting and further acceleration of vesting periods exceed the detriments associated with the mandates, the protections that section 510 offers should be included in the balance.

Variations of abusive characteristics arise from the concern that an employer might utilize a retirement plan as a mechanism to defraud employees. In stark terms, a plan might promise to pay retirement benefits, which the plan understands is a promise that it will not have to perform for many years and until after the employee has completed providing services for her entire working career, but then, when the time for the plan's performance arrives, the plan relies upon inadequately disclosed vesting provisions to deny the participant retirement benefits.[163] Employees do face great challenges in monitoring their own entitlement to retirement benefits. A retirement plan

161 *Cf. supra* note 155 and accompanying text.

162 ERISA § 510, 29 U.S.C. § 1140 (1994).

163 *See, e.g.*, International Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979) (denying a remedy for fraud under the federal securities laws to a pre-ERISA retirement plan participant who failed to qualify for a pension from a union retirement plan because a seven month break in service prevented his satisfying the requirement for 20 years of continuous service).

creates a substantively complex legal structure; detailed and precise factual information must be gathered in order to predict the benefits that a particular participant may receive at any given time. Most employees have a very limited understanding of their retirement benefits in general and about conditions which might cause forfeiture in particular.[164] In fact, it may be entirely reasonable for an employee to fail to devote resources to learning the terms of her employer's retirement plan. During the early years of an employee's career, accrued retirement benefits have a small economic present value; this small value must be further discounted to the extent it is not fully vested.[165] And even this small economic value might be further undervalued since employees may systematically under-estimate the importance of retirement benefits.[166] Even if employees expend effort in an attempt to understand important aspects of their employer's retirement plan, there is little reason for optimism that their understandings will be accurate.[167] In most cases, monitoring of a retirement plan by participants is unlikely to directly and immediately constrain abusive action to a significant degree.

A more effective constraint on plan abuse exists. An employer has a strong incentive to honor its commitments under retirement plans in order to protect its reputation among its current employees.

---

164 *See, e.g.*, DAN M. MCGILL ET AL., FUNDAMENTALS OF PRIVATE PENSIONS 354 (1996).

> [O]verall measures of participants' knowledge of how their retirement programs are working is [sic] disappointing.
>
> ... In assessing covered workers' knowledge about their defined contribution plans, [the findings indicate] that only about half of those workers whose employers contribute to the plans believed that [the employers contributed].
>
> ... [D]ata ... suggest that retirement plan participants know little about their plans.

Id.

165 *Cf.* Wiedenbeck, *supra* note 120, at 574 ("For most workers, the cost of evaluating the specialized terms and particular finances of numerous alternative plans (associated with different employment opportunities) may exceed the benefit of a marginally more valuable pension.").

166 *See* POSNER, *supra* note 71, at 70–72; Weiss, *supra* note 60, at 1300–06.

167 Professor Kim recently reported data on workers' knowledge of the "at will" condition that applies to almost all non-unionized employment. The at will condition of an employment relationship is a far more simple and immediate component of the conditions of employment than the retirement plan and its extensive terms and conditions. Kim concluded that the "data reveal a striking level of misunderstanding among respondents of the most basic legal rules governing the employment relationship." Pauline T. Kim, *Bargaining with Imperfect Information*, 83 CORNELL L. REV. 105, 133 (1997).

This is known as the "reputational constraint." If the employer were to abuse its retirement plan and the retirement benefits of long-tenure employees or retirees, present employees would tend to (further) discount the value of their pension promises. The employer's retirement plan could no longer act as an effective compensation device for the sponsoring employer and any advantage that it could draw from the plan would be destroyed. Generally, the present value of the future gains to a sponsoring employer from continuation of its retirement plan would exceed any gains that an employer might reap from abusive forfeitures. So long as an employer expects to continue its business, the balance of the incentives that it faces clearly favors operating the plan so as to maximize the value that current employees assign to their expectancy of future retirement benefits.[168] When an employer and its employees opt to include retirement benefits in the employees' compensation packages, an implicit element of that choice is that the employer will administer the plan in a manner that realizes the parties' expectations.

The efficacy of the reputational constraint is validated by empirical studies. Prior to ERISA's vesting mandate, employers did not engage in a pattern of firing workers shortly before they became vested.[169] More broadly, the data directly refute the hypotheses that fraud was, or is, an important problem in the retirement plan system or that the risk of fraud discourages employees from participation in retirement plans.[170] Justification of mandated vesting as a response to retirement plan abuse should be an empirical exercise. The data that exist suggest that plan abuse does not offer strong grounds for imposi-

168 This analysis does not hold true in the case of an employer that is facing financial difficulty.

169 *See* Christopher Cornwell et al., *Opportunistic Behavior by Firms in Implicit Pensions Contracts*, J. HUM. RESOURCES 704, 721 (1991) ("Our results suggest that anecdotes of unvested workers fired just before retirement apparently were exceptions, not the rule, prior to ERISA.").

170 *See generally* POSNER, *supra* note 71, at 303 ("[T]here is no persuasive evidence that pension abuses were so widespread as to justify the imposition of a complex scheme of federal regulation. On the contrary, careful empirical research has shown that before ERISA opportunistic discharges of workers covered by a pension plan were rare and that ERISA has had no detectable impact on discharges of covered workers."); Richard A. Ippolito, *A Study of the Regulatory Effect of the Employee Retirement Income Security Act*, 31 J.L. & ECON. 85, 100–01 (1988) ("[N]o evidence was found to support the notion that fraud was an important problem in the pension market.").

Notwithstanding the lack of evidence, the theoretical potential for abuse of retirement plans figures prominently in discussion of the regulation of retirement plans, including vesting mandates. *See, e.g.*, ERISA § 1, 29 U.S.C. § 1001 (1994); GREENOUGH & KING, *supra* note 132, at 155.

tion of uniform mandated vesting on every retirement plan in the United States.

Plan participants also forfeit retirement benefits in entirely innocent circumstances—for example, upon termination of employment resulting from a natural disaster. In addition to the vesting provisions that have been discussed under the rubric of mandated vesting, other provisions of retirement plan law compel vesting in certain circumstances. If a retirement plan is terminated, in full or in part, the retirement benefits of participants affected by the termination must become fully vested when the plan termination is effective.[171] In cases in which an employer's business is terminated or substantially contracted, causing full or partial termination of its retirement plan, the retirement benefits of the affected plan participants will vest under this rule. This rule protects retirement plan participants from forfeiture in many cases of "innocent" termination of employment. The need for mandated vesting is mitigated by the existence of the plan termination vesting provisions.

Another variation of innocent termination of employment raises more difficult issues. Some employees are forced to quit a particular job for reasons completely unrelated to the job or the employee's career choices—for example, when an employee must leave employment for family reasons. In these cases, mandated accelerated vesting is the only public policy that will protect the employee from forfeiture. Of course the impact on business operations from the loss of an employee who quits for family reasons is the same as the impact from an employee who quits in order to take a better job. Loss of an employee imposes costs on the employer in addition to any costs imposed on the employee. In order to reduce these losses, some employers would choose deferred vesting. If that choice is the correct one for that employer and its workforce, both the employer and the employees may gain from increased job tenures.[172] The policy decision becomes a balance between the imposition of real economic losses on an "innocent" employee and the elimination of the possibility for economic gains from greater flexibility in retirement plan design. There is little reason to believe that the present schedule of mandated vesting represents any systematic or reasoned resolution of that balance.

171 *See* I.R.C. § 411(d)(3) (1994 & Supp. III 1997). The rules requiring full vesting upon full or partial termination of a plan are part of the nondiscrimination regime. *See infra* note 205 and accompanying text. *See generally* 1 CANAN, *supra* note 23, §§ 20.1–.3; LANGBEIN & WOLK, *supra* note 13, at 122.

172 *See supra* notes 69–73 and accompanying text.

In summary, protection of employee interests in retirement benefits does not offer any clear-cut justification for mandated vesting. The connection between retirement plan abuse and mandated vesting is ultimately an empirical question, and existing data does not establish that plan abuse was a substantial problem prior to the enactment of mandated vesting. Judgments about balancing equities among a sponsoring employer, its workforce generally, and the interests of individual short-tenure employees are just that—judgments. In reality, more vesting will come at the cost of reducing retirement benefits for U.S. workers. Prudence demands attention to the costs of mandated vesting before reformers simply assume that they are "improving" the lot of the worker.

III. Mandated Vesting and the Monolith of Retirement Plan Law

Legally imposed mandated vesting might appear to affect retirement plan design only by limiting the periods during which a participant's accrued retirement benefits might remain forfeitable. Appearances once again deceive. In order for mandated vesting to be *effectively* implemented, it is necessary to impose legal regulation on all other important elements in the design of a retirement plan. Regulation must constrain the of design the plan's rules that govern employees' participation, benefit accrual, crediting of employees' service, and the payment of benefits. These rules, together with the specific rules that limit the periods of forfeitability, form the mandated vesting regime, the subject of Section III.A. In addition, effective implementation of mandated vesting depends upon the existence of the nondiscrimination regime, a body of income tax law requiring that a retirement plan provide retirement benefits to at least some of the sponsoring employer's non-highly compensated employees, and that those benefits be reasonably comparable to the benefits provided to highly compensated employees. The nondiscrimination regime and its connections with mandated vesting are the subject of Section III.B.[173] If these additional supporting rules did not exist, mandated vesting could not protect employees with lengthy service from loss of retirement benefits.

Explication of these supporting rules is necessary to appreciate the full impact of mandated vesting on the private retirement plan system. The policy decision to regulate vesting implies the complete regulation of which employees may participate in a retirement plan,

173 *See infra* note 205 and accompanying text.

when those employees participate, the benefits that may be accrued by different employees, when those benefits accrue, and how and when the benefits may be paid to retired employees. This extensive and detailed regulation implies that fewer employers will be able to design a retirement plan that provides added value for an employer's workforce. Fewer retirement plans implies a loss of potential retirement benefits for those employees who are employed in workforces for which a value-adding retirement plan can no longer be designed. Mandated vesting has such a substantial impact on the voluntary retirement plan system because vesting rules are not simply about limitations on periods of forfeitability, but about limitations on all aspects of retirement plan design.

Twenty years ago, Dean Osgood characterized retirement plan law as having a "monolithic nature"; he suggested that "[i]n order for a person to approach one aspect of the subject, familiarity with the entire field is probably a necessity."[174] Osgood was right; retirement plan law really is a monolith. The analysis in this part demonstrates that mandated vesting is inseparable from the balance of retirement plan law. In his article, Osgood suggested a departure from the consideration of the entire monolith of retirement plan regulation. He proposed the consideration of a mandate requiring 100% immediate vesting as a separate and discrete change in retirement plan law.[175] In this respect, Osgood was wrong. A proper consideration of mandated vesting requires that vesting regulation be analyzed in the context of the entire employer-employee relationship. In American law, much of that relationship, including the choice of whether it will include retirement benefits, is left to the voluntary agreements of the parties. Against this background of voluntary choices, an effort to regulate one, seemingly discrete, aspect of the employer-employee relationship will inevitably lead the parties to adjust other elements of their arrangement. These longer-run effects on the totality of the employment relationship will tend toward returning the relationship to the closest possible approximation of the arrangement that existed prior to the legal mandate.

This process by which an employer and its employees adjust the voluntary aspects of their relationship elucidates the effects of mandated vesting. Prior to the enactment of mandated vesting standards, most retirement plans provided some level of vesting for participants in retirement plans.[176] That is, under a legal regime that permitted

174 Osgood, *supra* note 10, at 452–53.

175 *See id.*

176 *See supra* notes 82–83 and accompanying text.

voluntary design of retirement plan vesting schedules, different retirement plans evolved toward providing different levels of vested benefits to various participants, while at the same time providing for the forfeiture of the benefits of other participants. Vesting provisions varied across plans, employers, and industries. But plans were free to evolve toward maximizing their value to both employers and employees. In industries in which retirement plan design was an important competitive element, employers that provided the most efficient retirement plan designs would be most competitive and therefore most likely to succeed. In a voluntary system, retirement plans evolved toward those designs that allocated the greatest shares of the plan contributions to those participants who placed the highest value on retirement benefits. In other words, retirement plan design evolved toward the most efficient use of plan contributions.

When a new vesting mandate is introduced, some retirement plans are compelled to provide more rapid vesting than was provided under the pre-mandate schedule. The initial effect of accelerated vesting is to provide vested retirement benefits to some employees, the short-tenure employees, who did not receive benefits under a voluntary retirement plan design. Assuming that the pre-mandate vesting schedule represented the most efficient use of retirement plan contributions, after the vesting mandate the retirement plan (initially) will allocate retirement benefits to participants who place a lower value on those benefits. This situation is unstable because it creates an incentive for the plan to eliminate the allocation of benefits to short-tenure employees, and it creates a demand by long-tenure employees for a return to their prior level of benefits.[177] These incentives create a continuing pressure for retirement plan design to minimize or to avoid the impact of the vesting mandates. In order to forestall avoidance of the vesting mandates, Congress found it necessary to create a comprehensive structure of supporting rules.

A. *The Mandated Vesting Regime*

1. Participation of Employees

A retirement plan provides retirement benefits only to employees who "participate" in the plan; employees who have met all conditions for participation in the plan and who are accruing benefits under the plan are referred to as "participants."[178] Just as no law requires that

177 *See infra* notes 255–64 and accompanying text.

178 An employee is a "participant" in a retirement plan after she has met any requirements for participation—typically attainment of a minimum age and completion

employees receive any retirement benefits, no law requires that retirement benefits must be provided to all, or to any specific group, of an employer's employees. A retirement plan may be designed to cover a "reasonable classification" of employees who may become eligible to participate in a retirement plan.[179] This group of employees eligible to participate in a plan is referred to as the group of employees "covered" by the plan.[180] For example, a retirement plan may be designed to cover only salaried employees and to exclude hourly employees, or to cover only employees working in a particular division, subsidiary, or geographic location operated by the employer, or to cover employees who work in a particular job category.[181] Those employees who are not included in the classifications that are covered by the retirement plan are permanently excluded from the plan.

The design of a retirement plan to classify employees and to designate the groups to be covered and excluded has both voluntary and mandatory aspects. The general background norm is the voluntary choice to provide or not to provide retirement benefits to employees. However, the choices to provide benefits to particular groups of employees are constrained by the Code's nondiscrimination rules;[182] in the most general terms, the nondiscrimination rules mandate that if a retirement plan provides benefits to one or more "highly compensated employees," then the plan must provide some reasonably comparable benefits to "non-highly compensated employees."[183] The nondiscrimination rules include "minimum coverage requirements"

---

of a specified period of service—and has begun to accrue retirement benefits. "The term 'participant' means any employee or former employee of an employer . . . who is or may become eligible to receive a benefit of any type from an employee benefit plan . . . or whose beneficiaries may be eligible to receive any such benefit." ERISA § 3(7), 29 U.S.C. 1002(7) (1994).

179 *See* I.R.C. § 410(b)(2)(A)(i) (1994); Treas. Reg. § 1.410(a)-3(d) (amended 1991); *id.* § 1.410(b)-4(b) (recognizing that a retirement plan may establish reasonable classifications based upon objective, bona fide business criteria, but not classifications that have the effect of enumerating employees by name); *see also infra* note 219 and accompanying text.

180 A retirement plan may "cover" all employees of the sponsoring employer, or it may cover only a portion of the sponsoring employer's employees. A retirement plan "covers" a group of employees if employees included in that group are eligible to become participants in the plan upon completion of any conditions required prior to participation, such as an employee's completion of one year of service or the attainment of age 21. *See infra* notes 186–87 and accompanying text. The group of employees eligible for participation must be defined by a reasonable classification of employees. *See infra* note 219 and accompanying text.

181 *See* Treas. Reg. § 1.410(b)-4(b).

182 *See infra* notes 206–47 and accompanying text.

183 *See infra* notes 205–09 and accompanying text.

that impose specific requirements about the numbers of non-highly compensated employees who must receive benefits.[184] The important connections among the nondiscrimination rules, the minimum coverage requirements, and mandated vesting are explored below.[185] In the present context of regulation of employee participation, the essential idea is that a plan's designation of the group of employees to be covered is subject to mandatory regulation by the nondiscrimination rules. The classification of employees covered must be a nondiscriminatory group of employees.

After a retirement plan has identified a nondiscriminatory group of employees to be covered, the plan must establish rules governing which employees in that group actually will become participants in the plan. Of course the plan could simply extend participation to any employee who became a member of the covered group. This would imply that newly hired employees would begin participation with their first hour of service with the sponsoring employer. However, the typical retirement plan imposes some conditions prior to a covered employee becoming a participant in the plan; these conditions are usually the completion of a minimum period of service, attainment of a minimum age, or a combination of these conditions. The participation rules of retirement plan law forbid a plan from requiring an employee to complete, as a condition for participation in the plan, a period of service in excess of one year (two years if the plan provides 100% vesting upon completion of two years of service).[186] Any minimum age condition for participation may not exceed age twenty-one.[187] A typical retirement plan participation provision would state that an employee (in a covered group) shall become a participant in the plan after completing one year of service and attaining age twenty-one.[188]

If retirement plan law did not constrain a retirement plan's participation rules, participation requirements could impair or defeat a vesting mandate. For example, if a retirement plan could require that an employee complete twenty years of service prior to beginning par-

184 *See* I.R.C. § 410(b) (1994); *see also infra* note 233 and accompanying text.

185 *See infra* notes 245–53 and accompanying text.

186 *See* I.R.C. § 410(a)(1)(A)(ii) (1994); ERISA § 202(a)(1)(A)(ii), 29 U.S.C. § 1052(a)(1)(A)(ii) (1994).

187 *See* I.R.C. § 410(a)(1)(A)(i) (1994); ERISA § 202(a)(1)(A)(i), 29 U.S.C. § 1052(a)(1)(A)(i) (1994).

188 *See, e.g.*, 1 CANAN, supra note 23, at 1180. Actual entry in a plan may be deferred until the next plan "entry date," which may not be more than six months after completion of the conditions for participation. *See* I.R.C. § 410(a)(4) (1994); ERISA § 202(a)(4)(B), 29 U.S.C. § 1052(a)(4)(B) (1994).

ticipation in the plan, then an employee would not begin to actually accrue retirement benefits until late in her career of service.[189] Such a plan could provide a high rate of benefit accrual, so that the total retirement benefit might approximate that which could have been earned over a longer period of participation. This high rate of benefit accrual would be earned only by those who satisfied the lengthy conditions for participation, so that the effect would be functionally similar to long-deferred vesting. By constraining the design of a plan's participation rules, retirement plan law closes off this escape from mandated vesting.

The limitations on the period of service that may be required as a condition for participation compels a further set of rules defining a "year of service." In the absence of a mandated definition of a year of service, a retirement plan might define the term in such a way that only long-tenure employees would be likely to earn a year of service for participation. ERISA and the Code mandate that a retirement plan must grant every employee a year of service for participation purposes in any year during which the employee completes at least 1000 "hours of service" during a twelve-consecutive-month period.[190] Reference to "hours of service" brings this element of the employment relationship within the regulatory monolith: ERISA directs the Secretary of Labor to prescribe regulations defining an "hour of service."[191] The participation regulations ensure that an employee comes within the statutory protections as soon as she begins employment. Every employee (in a covered group) who satisfies the statutory minimum conditions is assured of participation in her employer's retirement plan. And participation sets the employee on a course that can lead to vesting, and ultimately, to receipt of retirement benefits.

2. Accrual of Retirement Benefits

The next layers of support for mandated vesting are the statutory minimum standards for a retirement plan's definition of the participant's accrued retirement benefit. After an employee has become a

189 One can envision various combinations of long-deferred participation requirements: a plan might require that an employee attain age 55 or perhaps satisfy some combination of age and years of service.

190 *See* I.R.C. § 410(a)(3) (1994); ERISA § 202(a)(3), 29 U.S.C. § 1052(a)(3) (1994). Participation in the plan must commence no later than six months after completion of the participation conditions. *See* I.R.C. § 410(a)(4) (1994); ERISA § 202(a)(4), 29 U.S.C. § 1052(a)(4) (1994).

191 *See* I.R.C. §§ 410(a)(3)(C), 411(a)(5)(B) (1994 & Supp. III 1997); ERISA §§ 202(a)(3)(C), 203(b)(2)(B), 29 U.S.C. §§ 1052, 1053 (1994 & Supp. III 1997); *see also infra* note 200 and accompanying text.

participant in her retirement plan, she begins to earn—that is, to accrue—a retirement benefit. In general terms, the participant's "accrued benefit" is the amount of retirement benefits that a participant has earned at any given time during her period of participation in a retirement plan. The definition of the accrued benefit is vital to the structure of mandated vesting, since it is this accrued benefit in which a participant must be granted vested rights.[192] In the case of a defined contribution plan, the participant's accrued benefit must be defined as the participant's individual account balance.[193] The individual account balance represents all of the retirement benefits that a participant has earned.[194] By requiring that a participant acquire vested rights in her account balance, the vesting mandate applies to all retirement benefits that the participant has earned.[195]

In the case of a defined benefit plan, the participant's accrued benefit is the amount of retirement benefit (calculated to begin at the normal retirement age) that a participant has earned based upon her years of service and compensation history through the date for which the accrued benefit is being determined. In concept, the Code and ERISA require that a defined benefit plan must provide that a participant's benefit accrues approximately evenly over her entire period of participation.[196] The concept that defined benefits accrue evenly over

192 *See* I.R.C. § 411(a)(1)–(2) (1994 & Supp. III 1997); ERISA § 203(a)(2), 29 U.S.C. § 1053(a)(2) (1994).

193 *See* I.R.C. § 411. In the case of a profit-sharing plan, there is no entitlement to accrual of a benefit; benefit accrual is dependent upon a contribution being made to the plan. The essence of a profit-sharing plan is that the sponsoring employer has no continuing legal obligation to contribute to the plan. However, if a contribution is made, it must be allocated among participants in the plan—that is, it must be added to the balance held in each participant's "individual account." In a defined contribution plan, all contributions must be allocated annually. The balance of each participant's account is the participant's "accrued benefit." Thus, if a contribution is made to a profit-sharing plan, then there necessarily must be an accrual of benefits for participants.

194 *See* I.R.C. § 411(a)(7)(A)(ii) (1994 & Supp. III 1997); ERISA § 3(23)(B), 29 U.S.C. § 1002(23)(B) (1994).

195 In the absence of this definitional constraint, a retirement plan might erode the vesting mandate by granting a participant vested rights in something less than all retirement benefits that she had earned as of a given date.

196 In extremely general terms, the accrual rules require a defined benefit plan to accrue the benefit of a participant on a roughly pro rata basis, over a period beginning no later than the participant's third year of service with the sponsoring employer, and ending at the participant's projected retirement at the plan's specified normal retirement age. For example, consider a case of a participant who completes seven years of service and then terminates employment. Assume that the participant is age 41 at the time of termination, and that the plan's normal retirement age is 65, so that period of 24 years must elapse between the participant's termination of em-

a participant's period of participation is imposed in order to prevent a defined benefit plan from "backloading" the participant's benefit accrual. Backloading would occur if the plan provided that disproportionately large portions of a participant's benefit were earned late in her career.[197] If backloading were permitted, a plan could evade mandated vesting by granting vested rights, but the actual benefit in which the participant was vested would be relatively small during some lengthy portion of the participant's career. Then, if a participant completed a substantial period of service, she would accrue the bulk of her pension late in her career.[198] Backloading would substantially

---

ployment and her receipt of a retirement benefit. The essence of a defined benefit plan is to provide a definitely determinable benefit at normal retirement age, so logic dictates that a participant who terminates employment prior to retirement age ought to receive something less than the retirement benefit received by a participant who works until retirement. In the case of our participant who terminated employment at age 41, assume that the plan imposed a one-year of service requirement prior to participation. Thus the participant began employment at age 34, began participation in the plan at age 35, had six years of service at termination, and would have had 30 years of participation if she had remained employed until normal retirement age. The fractional accrual rule treats the participant's retirement benefit as accruing evenly over these years, allocating 6/30's of the participant's projected retirement benefit at normal retirement age to her six years of plan participation. Six-thirtieths of the participant's projected retirement benefit is the participant's accrued benefit at the date of termination of employment. The various vesting rules are then applied to this accrued benefit.

197 The accrual rules limit the "backloading" of a participant's accrual of her benefit in a defined benefit plan. Benefit accrual would be backloaded when disproportionately large fractions of the benefit accrue in the last few years of the participant's plan participation. An explicitly backloaded defined benefit would approximate the effects of long-deferred vesting since long-tenure employees would earn much larger benefits than short-tenure employees.

198 Mandated vesting compels intensely detailed regulation of a participant's accrual of benefits under a defined benefit plan. If retirement plan law failed to regulate benefit accrual, the vesting mandate could be largely defeated. A retirement plan could provide, for example, that a participant would accrue no retirement benefits during the first two-thirds of her projected career of service, and that benefits would then accrue on a pro rata basis over the last one-third of the career. If a participant began to accrue benefits under a retirement plan at age 35, and assuming a normal retirement age of 65, the participant would have a projected accrual period of 30 years. If accrual were not required to be approximately pro rata, this participant would accrue no benefits until she had been employed for 20 years (when she would be 55 years old). Then during her last 10 years of participation, she would accrue her entire retirement benefit (in which she would always be 100% vested since she had long since completed seven years of service). In effect, if a plan were permitted to control the accrual of benefits, the plan would be able to substantially replicate the effects of long-deferred vesting. Regulation of the manner in which retirement plan participants earn their retirement benefits is necessary for the efficacy of mandated vesting.

replicate the effects of long-deferred vesting. The defined benefit accrual rules prevent this escape from mandated vesting. For the vesting mandate to be effective, retirement plan law must impose detailed regulation of benefit accrual.

3. Crediting Years of Service

The vesting rules require that a retirement plan grant a participant the mandated minimum vested rights in the participant's accrued benefits. The five-year cliff vesting schedule and the seven-year graded vesting schedule both define the required percentages of vesting with reference to the number of years of service which the participant has completed.[199] Obviously both of these schedules depend upon the definition of a "year of service"; that dependency necessitates regulation of the definition of a year of service. ERISA and the Code require that a participant be credited with one year of service for vesting purposes for each plan year in which she works at least 1000 hours for the sponsoring employer.[200] This requirement is buttressed by the mandate that all years of service must be taken into account for vesting (subject to numerous technical exceptions).[201] Labor regulations define "hour of service" and periods of service in hypertechnical detail. The original policy decision to mandate vesting inexorably leads to a regulatory regime that rests upon the details, hour by hour, of an employee's entire career of service with an employer.

For example, in the absence of restrictions on the definition of a year of service, a plan could limit the crediting of years of service for vesting purposes to service performed by employees after they had been assigned to, or promoted to, certain job classifications, such as "senior operator" or "team supervisor." These job classifications could be structured so that in general practice, the classifications were restricted to long-tenure employees. This would enable the plan to limit vesting to employees who completed periods of service that might be generally longer than those permitted under the years of service vesting rules. In order to prevent such indirect extensions of the permissible vesting periods, ERISA and the Code require that all years of service be taken into account for vesting, subject to exceptions.

199 *See supra* notes 99–100 and accompanying text.

200 *See* I.R.C. § 411(a)(5) (1994 & Supp. III 1997); ERISA § 203(b)(2)(C), 29 U.S.C. § 1053(b)(2) (1994). ERISA directs the Secretary of Labor to define "hour of service." I.R.C. §§ 410(a)(3)(C), 411(a)(5)(B) (1994 & Supp. III 1997); ERISA §§ 202(a)(3)(C), 203(b)(2)(B), 29 U.S.C. § 1053 (1994 & Supp. III 1997). The regulations define an "hour of service." 29 C.F.R. § 2530.200a-1 to .201-2 (1976).

201 ERISA § 203(b)(1) includes several pages of detailed statutory rules controlling which years of service may be disregarded for vesting purposes. *See* ERISA § 203(b)(1), 29 U.S.C. § 1053(a)(2)(B) (1994 & Supp. III 1997). The rules are repeated in the Code, *see* I.R.C. § 411(a)(4) (1994 & Supp. III 1997), and have spawned pages of detailed regulations, *see* Treas. Regs. § 1.411(a)-5 to -6 (amended 1980).

4. Time of Payment of Retirement Benefits

An effective mandated vesting regime also compels regulation of the time at which retirement benefits are to be paid to a participant. Even though a participant has vested rights to receive retirement benefits, those benefits are not paid to the participant until the occurrence of the time for payment as specified in the retirement plan. If the time for payment of benefits under a retirement plan were left unregulated, a plan could replicate at least one element of long-deferred vesting. As a hypothetical example, the plan could comply with participation, service crediting, accrual, and vesting rules, but the plan might provide that benefits would not be paid to a participant until the participant had completed twenty years of service. If a participant failed to meet such a service requirement, then the participant herself would never receive retirement benefits. (Of course, since the participant's benefit was "vested," the benefit could not be forfeited and it would have to be paid to some recipient at some point; hypothetically, the benefits might be paid after the participant's death to her designated beneficiary or other successor.[202]) This hypothetical plan could pay retirement benefits only to long-tenure employees, which is one of the important effects of a plan with long-deferred vesting.

ERISA and the Code preclude a retirement plan from approximating long-deferred vesting with the plan's benefit payment provisions. Retirement plan law requires that a plan begin actual payment of benefits reasonably promptly after the later of a participant's attaining the normal retirement age or actually retiring, unless the participant elects otherwise.[203] These provisions are necessary to insure that vested accrued benefits are actually paid to the participant as retirement benefits after the participant retires from active employment. In order for the vesting mandate to be effectively implemented, the time

---

202 Assuming that the successor is a natural object of the participant's bounty, the plan does provide an indirect benefit to a short-tenure employee. In this respect, the hypothetical plan does not represent a perfect replication of long-deferred vesting, which would limit all benefits to long-tenure employees.

203 *See* I.R.C. § 401(a)(14)(A) (1994 & Supp. III 1997); ERISA § 206(a)(1), 29 U.S.C. § 1056(a)(1) (1994). Even when a participant elects to defer receipt of her retirement benefits, payment must begin by the "required beginning date"; this date is the April 1 following the *later* of the calendar year in which the employee attains age 70 1/2, or the calendar year in which the employee actually retires. (The actual retirement rule does not apply to a five percent owner.) *See* I.R.C. § 401(a)(9)(C)(i) (1994 & Supp. III 1997). The required distributions rules are aimed to prevent excessive tax deferral. *See generally* LANGBEIN & WOLK, *supra* note 13, at 353.

Without limits on how long distribution of benefits could be delayed, an employer could design a retirement plan to provide that, in certain cases, vested benefits would be paid only after the participant's death.

at which a retirement plan may actually pay benefits to a participant must also be regulated.

5. Mandated Vesting and Retirement Plans

The initial policy decision to legally mandate the vesting of retirement plan participants' retirement benefits compels the adoption of this extensive regime of supporting mandates. Employee participation rules compel the plan to extend participation to every employee in a covered group who has completed one or two years of service. Every participant must accrue benefits and become vested in those benefits in accordance with the minimum standards set by ERISA and the Code. And retirement plan law sets the time at which retirement benefits must be paid. These elements are among the most important in the design of a retirement plan, since they determine which employees will participate in the plan, when participants will accrue and become vested in benefits, and when the retired participants will be paid retirement benefits. The impact of the mandated vesting regime on retirement plans extends far beyond a simple limitation on the period during which retirement benefits may be forfeitable.

In subjecting each of these fundamental elements of retirement plan design to mandatory regulation, retirement plan law has important effects upon every plan. Regulation of retirement plan design implies restricting the choices that are available to a plan about each of these design elements. These restrictions on retirement plan flexibility limit the extent to which a retirement plan may be designed to provide more retirement benefits to those employees who value the benefits most highly, while permitting the employer to compensate other employees with the other forms of compensation, usually wages, most highly valued by those employees. The elimination of substantial areas of design flexibility changes the incentives that motivate an employer and its employees to apportion compensation between retirement benefits and other forms of compensation, and in changing those incentives, ultimately reduces the coverage and benefits provided by the retirement plan system.[204]

B. The Nondiscrimination Regime

Thus far, analysis of the mandated vesting regime has demonstrated that mandated vesting limits retirement plan design flexibility with respect to employees who are within the group of employees covered by the plan, that is, those employees designated by the plan as

204 *See infra* notes 266–86 and accompanying text.

eligible to participate. However, the impact of the mandated vesting regime is extended far beyond this group of eligible employees by the nondiscrimination rules. In order to comply with the nondiscrimination rules, a retirement plan must take into account not only employees who might be covered by a plan if coverage were a voluntary matter, but it must also take into account virtually all employees in the employer's workforce. Nondiscrimination rules thus magnify the impact of mandated vesting on the retirement plan system.

1. The Nondiscrimination Norm

In the most general terms, the nondiscrimination norm[205] requires every tax-qualified retirement plan to provide "non-highly compensated employees" with retirement benefits that are reasonably comparable[206] to the benefits provided to "highly compensated employees."[207] As rough working definitions, the highly compensated employee group includes employees who earn more than $80,000 per year, and employees who own more than five percent of the employer; the non-highly compensated employee group will include all other employees.[208] The nondiscrimination norm forbids a retirement plan from engaging in "prohibited discrimination" *against* non-highly com-

205 The statutory text implementing this concept is deceptively simple: "A trust . . . forming part of a stock bonus, pension, or profit-sharing plan . . . shall constitute a qualified trust . . . if the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees. . . ." I.R.C. § 401(a)(4) (1994 & Supp. III 1997). The statute appears to be simple; however, the regulations explaining its application occupy 80 pages. *See* Treas. Reg. § 1.401(a)(4)-1 to -13 (amended 1993). The nondiscrimination regime relates only to the income tax qualification of a retirement plan; there is no counterpart in ERISA to the nondiscrimination rules. For descriptions of the nondiscrimination regime, *see generally*, 1 CANAN, supra note 23, §§ 10.1–.4; LANGBEIN & WOLK, *supra* note 13, at 199–261; Bankman, *supra* note 47, at 795–800; Bankman, *supra* note 45, at 599–601; Dilley, *supra* note 77, at 1139–63; Wolk, *supra* note 13, at 434–63.

206 *See generally* I.R.C. §§ 401(a)(4), 410(b) (1994 & Supp. III 1997). The relationship between the benefits of highly and non-highly compensated employees is described as "reasonably comparable" because the nondiscrimination regime does not require precise equivalence of benefits. For example, a retirement plan may benefit a smaller fraction of an employer's non-highly compensated employees than the fraction of highly compensated employees benefiting. In general terms, the fraction of non-highly compensated employees participating in a plan must be at least 70% of the fraction of highly compensated employees, or the benefits provided to non-highly compensated employees must be at least 70% of the benefits provided to highly compensated employees. *See* I.R.C. § 410(b)(1)–(2) (1994).

207 *See* I.R.C. § 414(q)(1) (1994); Treas. Reg. § 1.410(b)-9 (amended 1993); *see also infra* notes 227–29 and accompanying text.

208 *See infra* note 231 and accompanying text.

pensated employees in the provision of retirement benefits.[209] Determining whether prohibited discrimination occurs is done by arithmetical comparisons between the amounts of benefits provided to non-highly and to highly compensated employees.

The nondiscrimination norm is a response to the fact that in a purely voluntary retirement plan system, retirement plans would tend to provide disproportionately larger retirement benefits to highly compensated employees than to non-highly compensated employees.[210] There are both tax and non-tax reasons for this. Highly compensated employees are more likely to be higher-income taxpayers; the progressive structure of income tax rates implies that the income tax deferral on compensation paid in the form of retirement benefits will be more valuable for highly compensated employees.[211] Among

---

209 The statutory text of the nondiscrimination norm forbids discrimination *in favor of highly compensated employees*: "A trust . . . forming part of a stock bonus, pension, or profit-sharing plan . . . shall constitute a qualified trust . . . if the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees . . . ." I.R.C. § 401(a)(4) (1994).

Notwithstanding the statutory language, the only discrimination that is prohibited is discrimination *against non-highly compensated employees* as compared with highly compensated employees. This is because all other forms of discrimination are permitted. A plan may provide benefits exclusively for highly compensated employees if the sponsoring employer employs no countable non-highly compensated employees. *See id.* § 410(b)(6)(F) (1994); Treas. Reg. § 1.410(b)-2(b), -2(b)(5) (amended 1994). A plan may discriminate in favor of some highly compensated employees as compared with other highly compensated employees. A plan may also discriminate in favor of non-highly compensated employees; that is, the plan may provide these employees with retirement benefits more generous than those provided to highly compensated employees. A plan may also discriminate among non-highly compensated employees. *See id.* § 1.401(a)(4)-2(b)(2)–(3), -2(c), -3(b)–(c) (amended 1993).

210 The extent to which the nondiscrimination rules actually deliver retirement benefits to non-highly compensated employees depends upon the proportion of highly and non-highly compensated employees participating in a particular plan. If a plan covered 99 highly compensated employees and one non-highly compensated employee, that non-highly compensated employee probably would receive larger retirement benefits than the great majority of non-highly compensated employees. The efficacy of the nondiscrimination rules depends upon the proportions of highly and non-highly compensated employees participating in a particular plan. Thus, the nondiscrimination rules do not ensure in any systematic manner that the tax subsidy to retirement plans mainly subsidizes benefits for non-highly compensated employees. *See* Bankman, *supra* note 47, at 821–25.

211 *See supra* note 43 and accompanying text. If the special income tax treatment of retirement benefits were not limited, as an employee's compensation exceeded her current consumption needs, then both employer and employee would seek to pay any additional compensation in the form of tax-qualified retirement benefits. Income tax law absolutely limits the annual benefit accruals under a defined contribution plan for each participant to the lesser of $30,000 or 25% of the participant's compensa-

the non-tax explanations is the fact that a retirement plan is a savings vehicle for an employee, and highly compensated employees are more likely to prefer savings to wage compensation because higher-income individuals have a greater ability to save and may have a greater propensity for saving.[212] A retirement plan may also provide workforce productivity effects, and these effects are likely to be more pronounced among highly compensated employees.[213] In order to align retirement plan design with the preferences of employees and sponsoring employers, in an unregulated system retirement plans would tilt benefits to favor highly compensated employees.

The nondiscrimination norm predates mandated vesting. It was first expressed by the Revenue Act of 1942, which created the new condition for tax qualification: a retirement trust was tax-exempt only "if the contributions or benefits provided under the plan do not discriminate in favor of employees who are officers, shareholders, [supervisors], or highly compensated employees."[214] The norm was developed specifically to control abuse of the special income tax treatment of tax-qualified retirement plans.[215]

---

tion, and a defined benefit plan is limited to the accrual of a pension benefit of the lesser of $90,000 or 100% of the participant's average compensation for her highest three years of earnings, payable annually. *See* I.R.C. § 415(c)(1) (1994).

212 *See* Daniel I. Halperin, *Cash or Deferred Profit-Sharing Plans and Cafeteria Plans*, 41 N.Y.U. INST. ON FED. TAX'N 39 (1983) (arguing that lower and middle-income employees are least likely to save). The correlation between income and propensity to save is partially explained by the fact that higher-income individuals can afford to save; lower-income individuals must apply all or a larger fraction of their income for necessities. Given the greater propensity to save, higher-income individuals are likely to more highly value the non-tax (as well as tax) advantages of saving through an employer sponsored retirement plan; these advantages include economies of scale in investing and professional investment management and the desire for a precommitted savings arrangement. *See generally* LANGBEIN & WOLK, *supra* note 13, at 30–33.

If the receipt of compensation in the form of retirement benefits were left to the voluntary choices of employers and employees, it is likely that most retirement benefits would be provided to highly compensated employees. Over the long run, retirement benefits are a form of personal savings, and savings correlate positively with income. This relationship reflects the fact that higher-income individuals have greater resources and therefore have a greater ability to save. "Left to their own devices, employers will provide more generous pensions to high income workers." Weiss, *supra* note 60, at 1294.

213 *See* IPPOLITO, *supra* note 57, at 176–77.

214 Revenue Act of 1942, Pub. L. No. 77-753, § 162(a), 56 Stat. 798, 862 (1942) (amending I.R.C. § 165(a)(4) (1939)).

215 The nondiscrimination regime is generally believed to extend larger retirement benefits to a larger number of non-highly compensated employees than would receive benefits in a purely voluntary system. To the extent the regime is effective, it causes a retirement plan to use part of the income tax subsidy to the plan for funding

In the context of mandated vesting, if the nondiscrimination norm did not exist, it would be necessary to invent something like it. In the absence of the nondiscrimination rules, a retirement plan could largely replicate the effects of long-deferred vesting for particular categories of employees. Hypothetically, a retirement plan could define a classification of employees for coverage by the plan that would exclude short-tenure employees; after a short-tenure employee had accumulated some sufficient period of service, then she could move into an employee classification that was eligible for plan participation. With such provisions, a retirement plan could limit the payment of retirement benefits only to longer service employees. The nondiscrimination rules do not explicitly require plan coverage of the category of employees we refer to as short-tenure employees; instead they require coverage of non-highly compensated employees. However, in effect, coverage of non-highly compensated employees will provide retirement benefits to some, perhaps a significant proportion, of an employer's short-tenure employees.

There are four elements in the implementation of the nondiscrimination norm: the identification of the sponsoring employer's "countable" employees, the division of these employees into the highly and non-highly compensated categories,[216] comparison of the participation rates of highly and non-highly compensated employees,[217] and the comparison of the retirement benefits that are provided to each group.[218]

2. "Countable" Employees

As noted above, a retirement plan is not required to provide benefits to all of the sponsoring employer's employees. A retirement plan may limit coverage to a "reasonable classification" of employees, so that only members of that group become participants upon completion of any age or years of service requirements.[219] Limiting coverage

---

of retirement benefits for participants who would not otherwise accrue benefits. The efficacy of the regime in a given case depends upon the proportions of highly and non-highly compensated employees participating in the plan. *See supra* note 210.

216 *See* I.R.C. § 414(q)(1) (1994 & Supp. III 1997); Treas. Reg. § 1.410(b)-9 (amended 1993); *see also infra* notes 227–29 and accompanying text.

217 *See* I.R.C. § 410(b) (1994); *see also infra* notes 233–36 and accompanying text.

218 *See* I.R.C. § 401(a)(4) (1994 & Supp. III 1997); *see also infra* notes 237–42 and accompanying text.

219 *See* Treas. Reg. § 1.410(b)-4(b) (amended 1991) (recognizing that a retirement plan may establish reasonable classifications based upon objective, bona fide business criteria, but not classifications that have the effect of enumerating employees by name).

of a retirement plan to a particular classification of employees could be utilized by a plan as a means to restrict coverage mainly to highly compensated employees. A plan could provide benefits only to employees included in a salaried pay classification, and therefore exclude from participation all hourly-paid employees. Typically the salaried classification would include all highly compensated employees, and therefore they would receive benefits.[220] Typically all hourly-paid employees would be non-highly compensated employees. Thus the exclusion of hourly-paid employees from a "salaried-only" plan might result in the prohibited discrimination against non-highly compensated employees. In order to test for the prohibited discrimination, it is necessary to determine the total number of the sponsoring employer's non-highly compensated employees. If an excessively large proportion of the entire group of non-highly compensated employees are denied benefits by the salaried-only classification, the retirement plan will be disqualified.

Discrimination testing starts from the general rule that all of an employer's employees[221] will be counted in the tests,[222] excluding only those employees who have not met any generally applicable age and years of service requirements.[223] Thus, in the above example, all of the sponsoring employer's non-highly compensated employees, both salaried and hourly, will be counted in the discrimination testing. But this simple general rule, by itself, is insufficient to support an effective nondiscrimination regime. Hypothetically, a corporate employer could create a subsidiary corporation, segregate highly compensated employees in the parent and non-highly compensated employees in the subsidiary, and provide retirement plan coverage only for employees of the parent. To prevent such abuse, the nondiscrimination regime includes rules that treat all employees of certain controlled groups and affiliated groups as employed by a single em-

220 The salaried-only classification would provide coverage to non-highly compensated employees who are salaried. If the plan benefits a sufficient number of salaried, non-highly compensated employees, the plan will qualify.

221 Generally retirement plan law relies upon the common law definition to establish the employer-employee relationship, so it would appear that an employer's employees would simply be those workers who have entered into a common law employment relationship with a particular employer. With admirable circularity, ERISA defines an "employee" as an "individual employed by an employer." ERISA § 3(6), 29 U.S.C. 1002(6) (1994).

222 *See* I.R.C. § 410(b)(1).

223 The nondiscrimination rules are applied by excluding employees who have not yet satisfied any age or years of service conditions for participation in the plan. *See id.* § 410(b)(1)(A).

ployer.[224] This means that when any employer entity within a defined controlled group or affiliated group sponsors a retirement plan, the occurrence of prohibited discrimination will be tested with reference to all of the employees of all employers within the controlled or affiliated group.[225] These employees who must be included in the testing for prohibited discrimination are referred to as the "countable" employees.[226] These rules expand the universe of countable employees to include all the employees of a specific sponsoring employer as well as employees of other related employers.

3. Highly and Non-Highly Compensated Employees

After a retirement plan has identified a universe of countable employees, those employees must be divided into the highly and non-highly compensated employee groups. A highly compensated employee is an employee who is a five percent owner of the employer, or who received compensation in excess of $80,000 during the prior year

---

224 *See id.* § 414(a)–(b), (m) (1994 & Supp. III 1997).

225 *See id.* The nondiscrimination rules also address another means by which a retirement plan could abuse the employer-employee definition to manipulate discrimination testing. An employer could avoid the formal employer-employee relationship by having another person act as the employer of workers who provided services to a retirement plan sponsor. Such an arrangement is commonly known as employee leasing. The nondiscrimination regime includes rules that treat certain "leased employees" not as employees of their actual employer, but as employees of the person to whom the leased employees provide services. *See id.* § 414(n) (1994 & Supp. III 1997). Thus, if an employer sponsors a retirement plan and receives services performed by leased employees, under certain circumstances the leased employees will be counted as employees of the sponsoring employer.

The controlled group rules cast an extremely broad net. In the case of a group that includes operations in different industries, each of which may have its own patterns for provision of retirement benefits, the controlled group rules could make it economically impossible to provide retirement benefits in one industry while leaving employees in another industry without benefits. In this circumstance, a controlled group would face a competitive disadvantage as compared with independently owned operations in each industry. Recognizing this problem, the Code provides relief from the controlled group rules for an employer that can establish that it operates "separate lines of business." *See id.* § 410(b)(5) (1994), *id.* § 414(r) (1994 & Supp. III 1997). The separate lines of business regulations, commonly referred to as the SLOB regulations, obligate a retirement plan to demonstrate that its coverage reflects business realities and is not a subterfuge for evasion of the nondiscrimination regime. *See* Treas. Reg. § 1.414(r)-0 to -11 (amended 1994).

226 Employees who have met these age and years of service requirements are countable employees. They must be counted in computing the percentages of employees participating in the plan under I.R.C. § 410(b)(1)–(2) (1994).

and, if the employer elects, is also in the "top-paid group."[227] The top-paid group consists of the top twenty percent of an employer's employees when ranked on the basis of compensation.[228] Perhaps unsurprisingly, a non-highly compensated employee is an employee who is not a highly compensated employee.[229] Because the compensation threshold for the highly compensated group is set at the relatively high level of $80,000, only a small fraction of most employer's workforces will fall into that group. Data from the March 1997 Current Population Survey indicate that only 4.2% of all workers earned $80,000 or more.[230] Based on compensation alone, the highly com-

---

227 The term "highly compensated employee" is partially defined by I.R.C. § 414(q)(1) (1994 & Supp. III 1997):

> The term "highly compensated employee" means any employee who—
> (A) was a five percent owner at any time during the year or the preceding year, or
> (B) for the preceding year—
> (i) had compensation from the employer in excess of $80,000, and
> (ii) if the employer elects the application of this clause for such preceding year, was in the top-paid group of employees for such preceding year.

Id. The seeming simplicity of this paragraph is belied by the fact that the highly compensated employee definition continues for eight more paragraphs of the statute, *see id.* §§ 414(q)(2)–(9), and requires 12 pages of regulations, *see* Temp. Treas. Reg. § 1.414(q)-1T (amended 1994).

The $80,000 threshold is referred to as the I.R.C. § 414(q)(1)(B) amount; it is subject to inflationary adjustments. *See* I.R.C. § 414(q)(1). The I.R.C. § 414(q)(1)(B) amount remains at $80,000 for 1999. *See* IR-News Rel. 98-63, 16 Comp-Vol Stand. Fed. Tax Rep. (CCH) ¶ 46,584 (1998).

228 *See* I.R.C. § 414(q)(3) (1994 & Supp. III 1997). If an employer has a highly-paid workforce, more than 20% of the employees might receive compensation in excess of $80,000. By exercising the top-paid group election, the employer can limit the highly compensated employee group to the 20% of its employees who receive the highest compensation.

229 "'Non-highly compensated employee' means an employee who is not a highly compensated employee." Treas. Reg. § 1.410(b)-9 (amended 1993). Note the distinction in terminology between a "short-tenure employee" and a "non-highly compensated employee." A "short-tenure employee" is, by the definition adopted in this analysis, an employee who receives a retirement benefit solely because of a vesting mandate. *See supra* note 124 and accompanying text. A "non-highly compensated" employee is described by the definitions of retirement plan law for the purpose of identifying those employees who must receive sufficient benefits so that a retirement plan is deemed to be nondiscriminatory.

230 *See* BUREAU OF LABOR STATISTICS & BUREAU OF THE CENSUS, ANNUAL DEMOGRAPHIC SURVEY, at tbl. NC8 (Mar. 1997) <http://ferret.bls.census.gov/macro/031998/noncash/8-001.html> (copy on file with Journal). The total number of workers was reported to be 144,582,000; 6,093,000 were reported in compensation categories of $80,000 and above.

pensated employee group would be a very small group. The five percent ownership group expands the highly compensated employee category; this criterion affects a business in which an individual both owns five percent or more and is employed in the business.[231] As a rough working concept, the highly compensated employee group can be thought of as including the most highly paid employees and the owners of closely held businesses who also work in the business; in general terms, this group will be a very small fraction of all workers. Almost all short-tenure employees will be included in the non-highly compensated employee group.[232]

4. Minimum Coverage Requirements

The nondiscrimination regime includes a set of rules known as the minimum coverage requirements.[233] These rules specify minimums for the proportion of non-highly compensated employees who must benefit under a retirement plan when that plan benefits one or more highly compensated employees.[234] There are several alternative tests, and if a plan satisfies any one of the tests, then it has complied with the minimum coverage requirements. The tests are expressed as arithmetic relationships between the numbers of highly and non-highly compensated employees benefiting from the plan. For example, if a plan covers 100% of the sponsoring employer's highly compensated employees, it would be tax-qualified if it also covers at least seventy percent of the sponsoring employer's countable non-highly compensated employees.[235] There is immense complexity in the rules

---

231 A retirement plan may provide benefits only to employees. *See* I.R.C. § 401(a) (1994 & Supp. III 1997). The 5% ownership criterion is most often met in closely held business; if an employer is not closely held, it is unlikely that any single individual would own 5% of the employer.

232 *See infra* note 246 and accompanying text.

233 *See* I.R.C. § 410(b) (1994).

234 If an employer had no countable non-highly compensated employees, its retirement plan could benefit exclusively highly compensated employees. There would be no non-highly compensated employees against whom the prohibited discrimination would have occurred. *See* § 410(b)(6)(F); Treas. Reg. § 1.410(b)-2(b)(5) (amended 1994).

235 *See* I.R.C. § 410(b)(1)(B). There are many permutations and variations of the coverage requirements. Generally these rules test the percentage of non-highly compensated employees who actually participate in a plan, *after application of any employee classification rules.* Thus if an exclusion of hourly-paid employees from eligibility for the plan caused only 50% of the employer's countable non-highly compensated employees to participate in its plan, the plan would fail the 70% test, and the plan would not be qualified. In order to bring additional hourly-paid employees into the plan, the plan would have to expand its eligible classes of employees so that another group

explicating the minimum coverage requirements; alternative numerical, bright-line tests are available, but if a plan fails to provide benefits to a sufficient number of non-highly compensated employees, it will lose its tax qualification.[236]

---

constituting 20% of the countable non-highly compensated employees became participants. The minimum coverage requirements limit the extent to which employee classifications can be used to exclude non-highly compensated employees from plan participation.

A different and more complex application of the coverage requirements permits a plan to provide benefits to as few as 20% of the countable non-highly compensated employees. *See* Treas. Reg. § 1.410(b)-4 (amended 1991). The example of 20% of the countable non-highly compensated employees participating is an application of the nondiscriminatory classification test. *See id.* It is based upon the safe and unsafe harbor percentages in Treas. Reg. § 1.410(b)-4(c)(4)(iv) and would be applicable if 99% of the employer's employees were non-highly compensated employees. *See id.* Note that it is also necessary for a plan relying upon the nondiscriminatory classification test to comply with the average benefit percentage test of Treas. Reg. § 1.410(b)-5. *See id.* § 1.410(b)-2(b)(3) (amended 1994); *id.* § 1.410(b)-5 (amended 1993).

The minimum coverage requirements rely upon a percentages based upon the sponsoring employer's highly and non-highly compensated workforces. This concept necessitates a definition of the "sponsoring employer." The Code relies upon a controlled group concept to define the relevant workforce. However, the controlled group concept would create serious problems for an employer that was diversified into several different industries or geographic regions that require varying compensation structures for the workforces. These problems are addressed by the separate line of business regulations.

236 *See id.* § 1.410(b)-4. A retirement plan might utilize the rules that permit fairly free choice of employee classifications to largely replicate the effects of a retirement plan with long-deferred vesting. For example, the plan could exclude from coverage certain job classifications to which all newly-hired employees were assigned. Other job classifications would be available to employees with longer tenures, and the retirement plan would cover only employees in these latter classifications. When an employee did move into a covered classification, participation in the plan could be immediate, and accrual of benefits could be rapid, thereby replicating the effects of a retirement plan that offered broader coverage, but with long-deferred vesting. This use of job classifications would frustrate the implementation of vesting mandates.

There is nothing in the legal structure of the mandated vesting regime that explicitly forbids such a pattern of operation. However, the covered job classifications would have to comply with the regulation that requires that employee classifications be based upon a bona fide business criteria. *See id.* § 1.410(b)-4(b); *see also supra* note 221 and accompanying text. If the job classifications were obviously surrogates for long-deferred participation and vesting rules, it is likely that the IRS would determine that the plan was not a qualified plan. Even if the employee classifications were valid, the covered job classifications would have to yield a sufficient number of non-highly compensated participants so that the plan could pass the nondiscriminatory classification tests. *See infra* note 237. As a practical matter, this might be difficult. To some extent, compensation correlates positively with job tenure, so that an employee classification populated mainly by long-tenure employees is likely to have a disproportionately high number of highly compensated employees.

5. Nondiscrimination in Benefits

The next element of the nondiscrimination regime is the mass of rules requiring nondiscrimination in benefits.[237] As noted above, the minimum coverage requirements ensure that some non-highly compensated employees will participate in a plan; the rules requiring nondiscrimination in benefits ensure that these participating non-highly compensated employees will accrue benefits that are reasonably comparable with the benefits that highly compensated employees accrue. The nondiscriminatory benefits regulations create numerous alternative arithmetic tests for determining whether the benefit structure of a particular retirement plan results in the prohibited discrimination. The most simple of the nondiscrimination requirements finds a plan to be nondiscriminatory if the plan accrues benefits at the same rate for both highly and non-highly compensated employees. For example, a defined benefit plan that provided every participant with a pension equal to thirty percent of the participant's average compensation would be nondiscriminatory, since the non-highly compensated participants would receive the same benefit accruals as highly compensated participants.[238] The numerous exceptions and alternatives permit retirement plans to accrue benefits at different rates for differ-

237 *See* Treas. Reg. § 1.401(a)(4)-0 to -13 (amended 1993).

238 *See id.* § 1.401(a)(4)-3(b)(2). The plan is nondiscriminatory because it provides benefits at a uniform rate to all participants, both highly and non-highly compensated employees. In a defined benefit plan, average compensation is typically defined as an average over some portion of the participant's career, such as the five years in which the participant had her highest compensation.

In the interests of brevity, the nondiscrimination rule will be described as requiring nondiscrimination in benefits only. Typically a defined contribution plan would comply with the nondiscrimination rules by allocating the contributions to the plan among highly and non-highly compensated participants in a manner that does not discriminate against the non-highly compensated employees. An allocation among participants that provides that each participant receive an allocation of the contribution which is a uniform percentage of that participant's compensation for the plan year is nondiscriminatory. For example, an employee who earns $15,000 could receive an allocation of $1500, which is 10% of compensation, while an employee who earns $150,000 could receive an allocation of $15,000. *See id.* § 1.401(a)(4)-2(b)(2). Since the allocation of contributions under a defined contribution plan is equivalent to the accrual of benefits for the plan participants, the nondiscrimination rules can be capsulized as prohibiting discrimination in the accrual of benefits. A defined benefit plan typically complies with the nondiscrimination rule by accruing benefits for non-highly compensated employees that are sufficiently equivalent to the benefits accruing for highly compensated employees. *See id.* § 1.401(a)(4)-3.

The IRS does permit a defined contribution plan to establish that it is nondiscriminatory by comparing the benefits to be received by participants, and a defined benefit plan may satisfy the nondiscrimination rule by comparing the annual cost of ent employees, but ultimately, these alternatives may not have the effect of discriminating against non-highly compensated employees as a group in the accrual of benefits.[239]

Nondiscrimination in benefits is applied, not only to the accrual of benefits, but to each aspect of retirement benefits. "[A]ll optional forms of benefit, ancillary benefits, and other rights and features available to any employee under the plan" must be made available in a nondiscriminatory manner.[240] All provisions governing the vesting of participants' retirement benefits must be applied in a nondiscriminatory manner,[241] and participants' service must be credited in a nondiscriminatory manner.[242] These rules require that the retirement benefits provided to non-highly compensated participants be reasonably equivalent to the benefits provided highly compensated participants, not only in amount, but also in quality.

6. (Non)Discrimination in Operation

The extent to which a retirement plan participant is vested, or unvested, will ultimately affect the amount of retirement benefits that are paid to her. Obviously if a participant is 0% vested, she will receive no retirement benefits, notwithstanding her accrual of benefits under a plan that complied with the nondiscrimination regime. So long as a plan applies the same vesting schedule to both highly and non-highly compensated employees, the plan will remain qualified.[243]

---

the benefits funded for participants. These rules are known as the "cross-testing" rules. *See id.* § 1.401(a)(4)-1(b)(2), -8.

239 There is an important limitation on the principle of nondiscrimination in benefits that permits a retirement plan to "integrate" its benefits with those provided by the Social Security system. *See* I.R.C. § 401(l) (1994 & Supp. III 1997).

240 *See* Treas. Reg. § 1.401(a)(4)-4(a).

241 *See id.* § 1.401(a)(4)-1(c)(10), -11(c). For example, if a plan provided that the benefits of non-highly compensated employees vested under a seven year graded vesting schedule, and that the benefits of highly compensated employees were 100% immediately vested, the vesting provisions would be discriminatory and would not satisfy Treas. Reg. § 1.401(a)(4)-1(c)(10). *See id.* Therefore, the plan could not qualify under I.R.C. § 401(a)(4).

242 *See* Treas. Reg. § 1.401(a)(4)-1(c)(11), -11(d).

243 If the employer has complied with the mandated minimum vesting floors, the employer has thereby complied with the nondiscrimination requirement, absent a "pattern of abuse." The Code reads in relevant part:

> A plan which satisfies the requirements of this section [411] shall be treated as satisfying any vesting requirements resulting from the application of section 401(a)(4) unless—
>
> (A) there has been a pattern of abuse under the plan (such as a dismissal of employees before their accrued benefits become nonforfeitable) tend-

This conclusion stands even if non-highly compensated participants on average have shorter job tenures than highly compensated participants, achieve smaller vesting percentages, and therefore ultimately receive a lower rate of retirement benefits.[244] If a plan has complied with a mandated minimum vesting floor and applied the same vesting schedule to all participants, deferred vesting can result in non-highly compensated employees receiving retirement benefits at lower rates than highly compensated employees.

And so it is with the other aspects of nondiscrimination in benefits. So long as a plan complies with statutory or regulatory requirements, the actual payment of benefits to plan participants is not the focus of the principle of nondiscrimination in benefits. Even if highly compensated employees receive larger benefits as a percentage of their compensation because a higher percentage of them satisfy the conditions for participation, the plan is nondiscriminatory. The requirements of nondiscrimination are applied at each stage of an employee's participation in a retirement plan, and so long as each aspect of the employees' relationship to the plan is nondiscriminatory, then the benefits that employees ultimately do (or do not) receive are deemed to be nondiscriminatory.[245]

---

ing to discriminate in favor of employees who are highly compensated employees (within the meaning of section 414(q)), or

(B) there have been, or there is reason to believe there will be, an accrual of benefits or forfeitures tending to discriminate in favor of employees who are highly compensated employees (within the meaning of section 414(q)).

I.R.C. § 411(d)(1) (1994). The requirement for applying the same or a comparable vesting schedule to both highly and non-highly compensated employees follows from the regulations. *See* § 1.401(a)(4)-1(c)(11), -11(d).

If the IRS established that the smaller vesting percentages for non-highly compensated employees were the result of a "pattern of abuse," the plan could be disqualified. A pattern of abuse could be established by showing that the sponsoring employer terminated participants shortly before they achieved vesting and for the purpose of preventing participants from achieving vesting.

244 In the example, if benefits received were computed as percentages of the respective employees' compensation, the highly compensated employee group would have a higher percentage rate of benefits because the non-highly compensated employees would have forfeited much of their benefits. *See supra* note 243 and accompanying text.

245 *Cf.* Donald S. Collat, Note, *Discrimination in the Coverage of Retirement Plans*, 90 YALE L.J. 817 (1981) (proposing the use of Gini coefficients for § 410(b)(1) coverage testing).

C. *Mandated Vesting and Nondiscrimination*

Mandated vesting and the nondiscrimination norm enjoy a symbiotic relationship. The nondiscrimination rules are necessary in order for mandated vesting to provide retirement benefits to short-tenure employees, and reciprocally, regulation of vesting periods is necessary for the nondiscrimination rules to actually deliver benefits to non-highly compensated employees. Mandated vesting and the nondiscrimination rules support each other because the short-tenure employees are largely included in the non-highly compensated employee category.

1. Short-Tenure Employees and Non-Highly Compensated Employees

In a great majority of retirement plans, virtually all of the short-tenure employees will be included in the non-highly compensated employee group. About ninety-five percent of the total workforce would be classified as non-highly compensated employees, with only about five percent being in the highly compensated employee group.[246] If short-tenure employees were distributed evenly among all compensation levels, about ninety-five percent of them would be non-highly compensated employees. But the distribution of short-tenure employees is not even. Short tenure is associated with lower compensation.[247] Conversely, a common route for an employee to enter the

246 *See supra* notes 227–30 and accompanying text. The highly compensated group includes only about five percent of the total workforce, and all other employees will be non-highly compensated employees. Of course the non-highly compensated employee group would also include many long-tenure employees.

247 Mean tenure increases uniformly with compensation in the data below.

Percentage Distribution of Workers by Tenure at Current Job, 1988

Worker characteristic: 1988 earnings	Total (000s)	Years of tenure at current job: Less than 1	1–4	5–9	10–14	15 or more	Not reported	Mean tenure (yrs.)
$1–4999	2168	53	24	8	3	5	8	3
$5000–9999	8085	32	41	10	4	6	7	4
$10,000–14,999	13,542	22	43	15	7	8	5	5
$15,000–19,999	11,388	16	39	19	12	12	2	6
$20,000–24,999	9648	13	33	20	14	17	3	8
$25,000–29,999	6742	10	27	21	16	23	3	9
$30,000–49,999	11,369	9	28	21	14	26	2	10
$50,000 or more	3465	7	25	20	17	29	2	11
Not reported	6085	18	28	16	11	15	11	8

TURNER, *supra* note 10, at 30; *accord* Robert Topel, *Specific Capital, Mobility, and Wages: Wages Rise with Job Seniority*, 99 J. POL. ECON. 145, 147–48 (1991) (finding that increases in earnings over time are in fact attributable in significant part to tenure at a particular firm).

highly compensated employee group is to remain with the same employer for many years and to accumulate a large number of periodic compensation increases. Thus, the non-highly compensated employee group will typically be composed of a disproportionately large fraction of short-tenure employees, and the highly compensated employee group will typically be composed of a disproportionately large fraction of long-tenure employees.

The nondiscrimination regime compels a plan to provide reasonably comparable retirement benefits to non-highly compensated employees. Because the non-highly compensated employee group is composed disproportionately of short-tenure employees, the benefits that the nondiscrimination regime compels a retirement plan to provide will accrue disproportionately to short-tenure employees. Depending upon the exact make-up of a group of retirement plan participants, the nondiscrimination regime is more or less equivalent to a requirement to provide benefits to short-tenure employees. The nondiscrimination regime attempts to compel retirement plans to provide short-tenure employees and non-highly compensated employees retirement benefits that are reasonably comparable to the benefits provided to long-tenure employees and to highly compensated employees. The nondiscrimination regime demands an increased degree of equivalence between the benefits accruing to these groups of employees.

2. Mandated Benefits

The mandated vesting regime and the nondiscrimination regime are mutually interdependent. In the absence of the nondiscrimination rules, it would be simple for a retirement plan to sidestep mandated vesting through the use of employee classifications. Hypothetically, a plan could cover an employee group that included exclusively long-tenure employees. Employees would not participate in the plan until they achieved some minimum periods of service. This design would restrict retirement benefits to longer-serving employees, which would defeat mandated vesting. The nondiscrimination regime eliminates this design possibility because the long-tenure employees will be disproportionately highly compensated employees. The nondiscrimination rules will compel the plan to expand coverage to include a sufficient proportion of non-highly compensated employees, and in doing so, short-tenure employees will be included. Mandated vesting depends upon the nondiscrimination regime to bring short-tenure employees within the covered group of employees.

The nondiscrimination regime depends upon mandated vesting to ensure that benefits are actually paid to non-highly compensated employees. The nondiscrimination regime works in two stages. First a plan must extend participation to some non-highly compensated employees who would not have participated had coverage of the plan been left to voluntary design choices.[248] Second, the plan must accrue reasonably comparable benefits to all participating non-highly compensated employees. Once a benefit is accrued, mandated vesting increases the likelihood that some retired non-highly compensated employees will actually receive retirement benefits.

Earlier the term "mandated benefit" was used to describe a retirement benefit that a short-tenure employee receives because of the mandated increase in her vesting percentage.[249] The benefit that an otherwise nonparticipating non-highly compensated employees receives because of the combined operation of the nondiscrimination regime and mandated vesting can also be described as a mandated benefit. A mandated benefit is a benefit that an employee receives *solely* because of the requirements of retirement plan law. Legal requirements that attempt to compel a retirement plan to provide mandated benefits set up a series of effects on our voluntary retirement plan system.

IV. Effects of Mandated Vesting: Dynamic Analysis Concluded

This part completes the dynamic analysis of the effects of mandated vesting. Section A explains that, over time, the costs of mandated benefits must be shifted to the employees who receive those benefits. Short-tenure employees and non-highly compensated employees generally will be unwilling to accept the mandated benefits in exchange for wages. Since the private retirement plan system is voluntary, in the long run retirement plans will reduce the levels of retirement benefits provided to these groups of employees back to the levels that existed prior to the imposition of the benefit mandates. Section B demonstrates that the nondiscrimination regime will ensure that any reduction in the level of retirement benefits will be applied equally across all participants in a retirement plan. Benefits will be reduced for long-tenure employees and for highly compensated em-

248 Of course in a voluntary retirement plan system some plans would provide benefits to some non-highly compensated employees. For purposes of this analysis, the relevant non-highly compensated employees are those who participate solely because of the requirements of the nondiscrimination regime, employees who participate solely in order to satisfy the requirements for income tax qualification.

249 *See supra* note 125 and accompanying text.

ployees to levels reasonably comparable to the levels acceptable to short-tenure employees and non-highly compensated employees. Mandated vesting and mandated benefits cause a reduction in benefits for plan participants generally.[250] Section C argues that the mandated vesting and nondiscrimination regimes constrict the extent to which retirement plan design can provide benefits to the categories of employees who value those benefits more highly than the cost of the benefits. Thus, fewer retirement plans are economically feasible. Retirement plan regulation is an important element in the stagnation of retirement plan coverage since 1974.[251]

A. *No Enhancement of Benefits of Short-Tenure Employees*

Legal requirements that a retirement plan pay mandated benefits to short-tenure employees and non-highly compensated employees are ineffective in the long run. In developing this proposition, it is essential to focus on the precise meaning of mandated benefits; they are benefits that an employee receives *solely* because of legal requirements.[252] In the absence of mandated vesting, many employees would satisfy job tenure requirements and receive retirement benefits. In the absence of the nondiscrimination regime, many non-highly compensated employees would receive retirement benefits. In these cases, an employer and certain of its employees would have voluntarily agreed to include forfeitable retirement benefits as a portion of these employees' compensation packages. In general, in a purely voluntary retirement plan system, retirement plans would provide that level of retirement benefits that maximized the value of the employer's compensation budget for both the employer and the employees. Employees would receive retirement benefits so long as they were willing to accept those benefits instead of other forms of compensation. Analysis of the effects of legal mandates begins from the assumption that a voluntary system would deliver that level of benefits that employees would voluntarily choose.

In the long run, the costs of retirement benefits are borne by the employees who receive those benefits. This fact can be obscure. First, as a matter of form, the sponsoring employer appears to pay the costs of a retirement plan; it is the party that actually remits the contributions to the trust fund. However, simply because the employer is the nominal payer of the contributions, it does not follow that the employer bears these costs over time. Second, when a vesting mandate is

250 *See infra* note 264 and accompanying text.
251 *See infra* note 270 and accompanying text.
252 *See supra* note 249 and accompanying text.

newly enacted, some or all of the costs associated with the initial shock will be borne by the sponsoring employer. In the case of a defined benefit plan, the sponsoring employer is legally obligated to fund the plan adequately, and therefore, it must initially bear the costs associated with the payment of newly mandated retirement benefits.[253] In the case of a defined contribution plan, if the sponsoring employer increases contributions to protect the benefits of the long-tenure employees, then it will initially bear the costs.[254] In both cases, the immediate effect of the vesting mandate appears to be to grant short-tenure employees an increase in total compensation equal to the value of the newly mandated retirement benefits that they receive, with the cost of that increase being borne by the employer.

A legally mandated compensation increase for short-tenure employees does not represent a stable arrangement, assuming that the employer that sponsors a retirement plan operates in a competitive product or service market. If the market is competitive, the employer that sponsors a retirement plan will face competition from another employer that may never have sponsored a retirement plan or that may have terminated its retirement plan in response to the vesting mandate. The competitor will be paying its short-tenure employees compensation that does not include mandated retirement benefits,[255] and it will have a cost advantage over the retirement plan sponsor. In order to remain competitive, the retirement plan sponsor will be compelled to reduce its compensation costs for its short-tenure employees to the level that existed prior to the imposition of the vesting mandate.[256] The sponsoring employer's alternatives are to reduce the

253 *See supra* note 135 and accompanying text.

254 If contributions to plan remain constant, the costs of newly mandated benefits are initially borne by long-tenure employees. *See supra* note 132 and accompanying text.

255 By definition the short-tenure employees are willing to accept compensation packages that do not include retirement benefits, since, prior to the mandate, they received no retirement benefits.

256 In economic substance, an employer that operates in a competitive market is a representative of the parties involved in the process of production and consumption. The employer attempts to organize capital and labor together in a productive and profitable combination. The employer must provide compensation and working conditions sufficient to attract an adequate number of workers with the requisite skills; in this sense, the employer represents its workforce. The owners of the employer, those who have supplied capital to it, demand sufficient returns from their investment; in the absence of adequate financial returns, over time the owners will withdraw their capital from the employer. And the employer must produce goods or services which customers will purchase at a price sufficient to cover the costs of production; the employer must serve the interests of its customers. From this perspective, the em-

wage portion of the compensation packages of short-tenure employees in an amount sufficient to cover the costs of mandated retirement benefits, or to eliminate the mandated retirement benefits.[257]

Competitive forces and the preference of short-tenure employees for wage compensation typically will drive a retirement plan to eliminate the mandated benefits that it is compelled to provide to short-tenure employees. Prior to a vesting mandate, short-tenure employees accepted wage compensation and did not choose retirement benefits as part of their compensation packages. Prior to the mandate, had the short-tenure employees preferred retirement benefits, the voluntary retirement plan design would have provided benefits to them.[258] This demonstrates that the short-tenure employees prefer wage compensation to retirement benefits. Suppose that in response to a vesting mandate, an employer that sponsors a retirement plan attempted to reduce the short-tenure employees' wage compensation in order to cover the costs of mandated benefits. Assuming that a competing em-

---

ployer cannot bear costs itself; it is the representative who must allocate costs among labor, capital and customers.

257 This choice is confirmed by economic theory.

> Our theory suggests that employers probably will not—and in a competitive market cannot—absorb the added pension costs. Those firms for which pension costs are increased will have to hold the line on future wage increases to remain competitive in the product market, and over time the wages they pay will fall below the level that would have held had it not been for the pension reform legislation [imposing mandated vesting]. Alternatively, firms whose expected pension costs rise because of vesting may choose to offset this rise with a reduction in promised pension benefits. In either case, theory suggests that workers bear the added costs, as well as reap the benefits, of the mandated change in vesting.

RONALD G. EHRENBERG & ROBERT S. SMITH, MODERN LABOR ECONOMICS: THEORY AND PUBLIC POLICY 279 (6th ed. 1997).

The economic theory is supported by empirical research. "[T]he few statistical studies on this subject tend to support the prediction of a negative relationship between wages and benefits." *Id.* at 277.

A reduction in wage compensation resulting from the addition of mandated retirement benefits would not occur contemporaneously with employees' accrual of the mandated benefits. The foregone wage compensation results in future periods by means of smaller increases in wages than might have occurred if no retirement benefits were provided. In addition, there is not necessarily a perfect dollar correspondence between the costs of retirement benefits and the foregone future wages. And the costs of increased retirement benefits might be borne by employees not only through a reduction in the employees' wage compensation, but also through reductions in forms of in-kind compensation other than retirement benefits. However, the theory posits that there is a significant relationship between the provision of retirement benefits and reductions in other forms of compensation.

258 *See supra* note 250 and accompanying text.

ployer provides no retirement benefits, the competing employer will be able to offer higher wage compensation. Short-tenure employees can receive higher wage compensation from an employer that does not provide retirement benefits. The retirement plan sponsor will have a disadvantage in the employment of short-tenure employees who prefer wage compensation. Since short-tenure employees prefer wages to retirement benefits, competitive pressures force the retirement plan to eliminate mandated benefits from the compensation packages of short-tenure employees.[259]

The proposition that mandated benefits will typically be eliminated from a retirement plan is also supported by empirical analysis. Short-tenure employees generally are likely to place a lower value on

259 Of course short-tenure employees' acceptance of the substitution of retirement benefits for wage compensation is not an all-or-nothing proposition. Mandated retirement benefits can be substituted for wage compensation in the compensation packages of short-tenure employees up to a limitation that the *value* of the total compensation packages provided to short-tenure employees cannot be reduced below the value that existed prior to the vesting mandate. Retirement benefits can be substituted for wage compensation in the compensation packages of short-tenure employees, but the *total value* of the compensation packages to short-tenure employees must be maintained. If short-tenure employees attach a lower value to additional mandated retirement benefits than the cost of providing those benefits, then the full cost of those benefits may not be shifted to the short-tenure employees. If the wage portion of these employees' compensation packages were reduced to reflect the full cost of additional retirement benefits, the total value of their compensation packages would fall, since the employees attach a lesser value to the retirement benefits. And since, in a voluntary retirement plan system, other employers can offer compensation packages with a larger proportion of wage compensation, over time employees who place a lower value on retirement benefits will migrate to employers who do not include retirement benefits as a part of compensation.

The compensation reduction may not exceed the *value* of the mandated retirement benefits to the short-tenure employees. This value would almost certainly be less than the cost of the mandated benefits to the employer. (The value of retirement benefits to employees and the cost of those benefits to the employer must be adjusted for the income tax advantage accorded to compensation paid in this form.) An older, highly compensated employee might value her tax-deferred interest in a retirement trust more highly than the cost to the employer of the contribution to fund that interest. This highly compensated employee might be willing to forego more in wages than it would cost the employer to purchase retirement benefits for her. Conversely, a young, non-highly compensated employee might attach a very low value to an interest in a retirement trust, and might have a strong preference for current wage compensation. This employee might be unwilling to accept employment that reflected any implicit reduction in wages in exchange for retirement benefits. To the extent an employer is required to provide retirement benefits to this employee, then the cost of contributions will yield little or no value. Consideration of the cost of retirement benefits cannot be separated from the questions of which employees will receive the benefits and what value will be attached to the benefits by these employees.

additional mandated retirement benefits than the full cost of those retirement benefits. This is because short-tenure employees are generally younger employees. There is a fairly typical pattern of job tenures among U.S. employees.

The typical career will involve a modest number of short-term jobs (when the young worker is job shopping) followed by one or two jobs of long duration. Thus if we ask the average duration of all jobs that began in 1983, the answer is fairly short—perhaps as brief as three or four years. But if we define the significance of long-term jobs (for example, those jobs lasting fifteen years or more) in the context of a worker's career, we find them quite important in the sense that the typical worker will spend most of his working life in one or two such jobs.[260]

---

260 *See* DOUGLAS A. WOLF & FRANK LEVY, *Pension Coverage, Pension Vesting, and the Distribution of Job Tenures, in* RETIREMENT AND ECONOMIC BEHAVIOR 26 (Henry J. Aaron & Gary Burtless eds., Brookings Inst. 1984); *see also* TURNER, *supra* note 10, at 18 ("Job changes generally occur in the first few years after employment begins. Young workers change jobs a great deal until they find a good career match.").

> Sehgal (1984) states that employment data . . . support the contention that mature American workers, on average, show substantial job stability. . . . Sehgal's principal findings on tenure are the following:
>
> 1. One worker in six has been with his/her employer for at least 15 years.
> 2. Among workers age 45 and over, nearly one-third have been with their current employer for 20 years or more.
> 3. Tenure with one's employer is closely linked to tenure in one's occupation.

Id. (summarizing Ellen Sehgal, *Occupational Mobility and Job Tenure in 1983,* MONTHLY LAB. REV., Oct. 1984, at 18–23).

Contrary to popular belief, there is no reason to believe that this typical career pattern has changed materially since these data were analyzed.

> There is a general perception that the work force has become much more mobile in recent years than it was 20 or 30 years ago. This perception has led some analysts to conclude that defined benefit plans are not as effective in the delivery of retirement benefits as they used to be. Interestingly, disaggregation of the historical data on worker tenures does not support the general notion that workers have become inherently more job mobile in recent years. . . . The long-term trend of the tenure lines at various ages is somewhat positive since World War II.

MCGILL ET AL., *supra* note 164, at 344; *see also* PAUL YAKOBOSKI, DEBUNKING THE RETIREMENT POLICY MYTH: LIFETIME JOBS NEVER EXISTED FOR MOST WORKERS 1 (Employee Benefit Research Institute Issue Brief No. 197, May 1998).

> Over recent years, 1983–1996, median tenure among male workers dropped noticeably, but this decrease was concentrated among prime-age male workers. Despite this decline, tenure in 1996 was comparable with that of decades past. Tenure levels for female workers have risen consistently over

Younger employees generally will place a lower value on retirement benefits than older employees. Many younger workers perceive retirement as an event that is remote, unimportant, and perhaps uncertain. This tendency by the young to undervalue the importance of adequate savings for retirement is typically relied upon as one of the important justifications for public policy efforts to enhance retirement savings.[261] Apart from any irrational or myopic mistake about the importance, and therefore the value of future retirement benefits, it may be entirely reasonable for a young employee to largely disregard her retirement benefits and the importance of saving for retirement. During the job shopping phase of an employee's career, her accrued retirement benefits necessarily will have a small economic present value. And when the employee is young, it is especially difficult to assess and value what that employee's financial needs after retirement might be. A comparison of the small accrued retirement benefits with highly speculative and uncertain future post-retirement needs makes the retirement benefit appear to be of little value. Data indicate that employees have little understanding of the value of retirement benefits,[262] and this phenomenon is undoubtedly more pronounced

---

> time. Thus, the labor market has not experienced *radical* change over recent years with regard to job stability.

Id.

261 The failure of the young to accurately assess the importance of saving for retirement is sometimes described as myopic behavior. "In common sense terms, myopia is an irrational preference for present consumption over future consumption. In economic terms, myopia is a discount rate that is irrationally . . . higher than the [prevailing] interest rate." Weiss, *supra* note 60, at 1298. The effects of an irrationally high discount rate are compounded by a lengthy period during which that rate is applied, so that myopic behavior will have its most exaggerated effects on the young.

262 *See* McGILL ET AL., *supra* note 164, at 354.

> [O]verall measures of participants' knowledge of how their retirement programs are working is [sic] disappointing.
>
> . . . In assessing covered workers' knowledge about their defined contribution plans, [the findings indicate] that only about half of those workers whose employers contribute to the plans believed that [the employers contributed]. . . .
>
> . . . [D]ata . . . suggest that retirement plan participants know little about their plans.

Id.

Professor Kim recently reported data on workers' knowledge of the "at will" condition that applies to almost all non-unionized employment. (The at will condition of an employment relationship is a far more simple and immediate component of the conditions of employment than the retirement plan and its extensive terms and conditions.) Kim concluded that the "data reveal a striking level of misunderstanding among respondents of the most basic legal rules governing the employment relationamong young employees. Young, and hence, short-tenure employees will generally attach a low value to mandated additional retirement benefits.

Because short-tenure employees place a low valuation on additional retirement benefits, the full costs of those benefits may not be shifted to these employees. Prior to the vesting mandate, short-tenure employees bore the costs of retirement benefits that accrued only to those short-tenure employees who remained employed for a sufficient period to become vested in the benefits that accrued while they were unvested—that is, those short-tenure employees who became long-tenure employees. (The benefits that accrued to short-tenure employees who terminated prior to vesting were forfeited, so there was no cost for these benefits.) After the vesting mandate, all short-tenure employees receive vested rights, so the costs of their retirement benefits increase. These additional costs cannot be shifted to the short-tenure employees nor to the employer's customers or owners.[263] In order to eliminate the costs, the mandated benefits must be eliminated from the retirement plan.

Elimination of the mandated benefits for short-tenure employees will reduce the cost of contributions that must be paid to the retirement plan. This cost reduction will return the total cost of compensation for short-tenure employees to a competitive level. In general terms, over time and so long as retirement plan sponsorship and benefit levels are voluntary, a vesting mandate cannot compel short-tenure employees to accept a larger proportion of their compensation in the form of retirement benefits than the proportion that they will ac-

---

ship." Pauline T. Kim, *Bargaining with Imperfect Information*, 83 CORNELL L. REV. 105, 133 (1997).

263 The full costs of mandated additional benefits for short-tenure employees cannot be shifted to them because short-tenure employees will generally not place a high value on retirement benefits. *See supra* note 261 and accompanying text. If a particular employer's short-tenure employees did place a high value on retirement benefits, then the employer's retirement plan would voluntarily provide retirement benefits to those employees. By definition, mandated benefits are provided only to employees who do not voluntarily choose benefits in lieu of wage compensation. Since short-tenure employees who receive mandated benefits are by definition short-tenure employees who do not voluntarily choose retirement benefits, it follows that these employees under-value the retirement benefits. Hence the full cost of those benefits may not be shifted to them.

As noted above, employers will not be able to shift the costs of retirement benefits to customers, and the owners of the employer will not accept lower profits in order to pay short-tenure employees compensation in excess of market rates. *See supra* note 74 and accompanying text.

cept voluntarily.[264] In short, mandated vesting in a voluntary retirement plan system cannot cause employees to accept more retirement benefits than they want.

B. *Reduced Retirement Benefits for Plan Participants Generally*

In our voluntary retirement plan system, with the existing nondiscrimination regime, mandated vesting will ultimately reduce the level of retirement benefits provided by a retirement plan to its participants generally. As explained above, the vesting mandate will not result in short-tenure employees accepting the substitution of retirement benefits for wages in their compensation packages. Instead, a retirement plan that faces a mandate to provide benefits to short-tenure employees will find a way to eliminate those benefits that the law would extend to short-tenure employees. Generally the short-tenure employees will also be non-highly compensated employees; the nondiscrimination rules will then cause the elimination of benefits accruing for other participants in the plan.

The analysis begins from the proposition that short-tenure employees will be unwilling to accept the substitution of mandated benefits for wages, so that the retirement plan must eliminate the mandated benefits. As an initial iteration of the process of eliminating the cost of mandated benefits, consider a reduction in the rate of benefit accrual only for the benefits of short-tenure employees.[265] All short-tenure employees would receive vested retirement benefits, but they would vest in a smaller amount of benefit.[266] However, since the

264 These effects imply that, over the long run, a vesting mandate cannot cause an increase in the contributions that are paid to a retirement plan.

265 For example, a unit benefit pension plan could amend its benefit formula to provide that a participant would accrue benefits at the rate of three percent of compensation for the first 14 years of plan participation and at 25% of compensation for the fifteenth and subsequent years of participation. Apart from possible violation of the nondiscrimination rules, this benefit structure is entirely legal for a defined contribution plan. This type of benefit structure in a defined benefit plan, however, would violate the anti-backloading provisions of the accrual rules. *See supra* note 199 and accompanying text.

266 The short-tenure employees accrue benefits at a lower rate than prior to the vesting mandate. But all short-tenure employees become vested in this reduced benefit. In the absence of the vesting mandate, benefits accrued for all employees at a higher rate, but only those employees who remained employed, and who became long-tenure employees, would have received vested rights in this larger accrued benefit. At this step in the process of adjustment to mandated vesting, it would appear that the vesting mandate would have the effect of simply redistributing retirement benefits away from those short-tenure employees who ultimately became long-tenure employees, and toward short-tenure employees generally. The benefit reductions are incurred by those short-tenure employees who become long-tenure employees, but who

short-tenure employees are disproportionately non-highly compensated employees, the nondiscrimination rules effectively forbid a reduction in the benefit accrual rate that is specifically targeted at the benefits of short-tenure employees. A reduction in the rate of benefit accrual for short-tenure employees will disproportionately reduce the average rate of benefit accrual for the non-highly compensated employee group.[267] In order to avoid disqualification, the nondiscrimination rules will then compel the plan to reduce the rate of benefit accrual for highly compensated employees to a rate appropriately comparable to the rate for the non-highly compensated employees. This is the first step toward reduced retirement benefits: the lower rate for short-tenure employees compels a lower rate for highly compensated employees.

The next step in the adjustment process extends the lower benefit rate from the highly compensated employee group to all long-tenure employees. If the plan must reduce the benefit accrual rate of highly compensated employees, normal retirement plan design considerations dictate that the benefit rate be reduced for the remaining non-highly compensated employees whose benefit rate had not already been reduced—that is, the group of non-highly compensated employees who are also long-tenure employees. As a general plan design proposition, retirement benefits are more valuable to more highly compensated employees,[268] so retirement plans usually will not provide a higher rate of benefits to a less highly compensated employee group.[269] Generally, when a plan reduces the rate of benefits for short-tenure employees, the plan will simply reduce the benefit rate for all non-highly compensated employees. Thus, the need to

---

never make up the reduction in rate of benefit accrual that occurred while they were short-tenure employees.

267 When short-tenure employees' compensation comprises a greater proportion of the total of compensation of the non-highly compensated employee group than of the total compensation of the highly compensated employee group, this benefit formula results in a discriminatory accrual of benefit and consequent disqualification of the plan.

268 *See supra* notes 43–48 and accompanying text.

269 It would be possible to reduce the benefit accrual rate solely for highly compensated employees; this would comply with the nondiscrimination rules since the average benefit rate for highly compensated employees would not exceed the average rate for non-highly compensated employees even with the reduced accrual rate for short-tenure employees. However, this would result in non-highly compensated employees who are long-tenure employees accruing benefits at a rate higher than highly compensated employees. Since retirement benefits are most valuable to highly compensated employees, this would be an inefficient design for the employer's retirement plan.

reduce the benefit rate for short-tenure employees effectively causes a reduction in the benefit rate of the entire group of non-highly compensated employees.

In summary, the inability of a sponsoring employer to shift the costs of the additional mandated retirement benefits for short-tenure employees to those short-tenure employees will compel a reduction in the rate at which short-tenure employees accrue benefits. This reduction in benefit rate will cause a reduction in the level of retirement benefits provided to all participants in the employer's retirement plan.[270] It is a race to the bottom that starts with the benefits of short-tenure employees, that legally must include the benefits of highly compensated employees, and that carries down the benefits of non-highly compensated employees.

C. *Suppression of Retirement Plan Sponsorship*

The combined regulatory regime of mandated vesting and the nondiscrimination rules suppresses the number and coverage of retirement plans in our voluntary system. A sponsoring employer and a covered group of employees will choose to include retirement benefits in the employees' compensation packages so long as the plan provides added value for the employer and the plan participants. A plan provides value for the sponsoring employer by attracting the type of employees who will be most productive for the employer, bonding those employees to the employer, and facilitating the retirement of employees at a time when their contribution to the productivity of the workforce may begin to decline. A plan provides value to participants by reducing income tax liabilities, providing efficiencies in the investment of retirement savings, and preserving retirement savings for retirement purposes. All of these elements of added value depend upon the plan providing retirement benefits to those employees who place the greatest value upon retirement benefits. It is the long-tenure em-

270 In this respect, the operation of the mandated vesting regime is very similar to the effect of the nondiscrimination regime. The nondiscrimination regime ties together the levels of retirement benefits provided to non-highly and highly compensated employees; the highly compensated employees may not receive retirement benefits that are impermissibly larger than those provided to the non-highly compensated employees. Similarly, mandated vesting provides short-tenure employees with retirement benefits that are vested to the same degree as the benefits of long-tenure employees. By applying equal vesting to the benefits of both short-tenure employees and long-tenure employees, mandated vesting ultimately has the effect of limiting the retirement benefits of long-tenure employees to a level that is acceptable to short-tenure employees. The level of benefits for long-tenure employees is tied to the level of benefits accruing for short-tenure employees.

ployees and highly compensated employees who will value retirement benefits most highly.[271]

The combined regulatory regime drastically limits the ability of a retirement plan to provide benefits to long-tenure employees. Mandated vesting compels a retirement plan to provide retirement benefits to short-tenure employees, and the implementation of mandated vesting necessitates the close regulation of plan participation, benefit accrual, crediting of service, and time of benefit payment. Then the nondiscrimination regime levels the effects of the mandated vesting regime across all or substantial segments of the employer's workforce. The discriminatory benefits requirement attempts to extend benefits to these additional participants. The mandated vesting regime compels a retirement plan to provide benefits to participants who would not have received benefits in a system that left vesting unregulated. The nondiscrimination regime then compels a retirement plan to provide reasonably comparable benefits to employees who would not even have been plan participants in an unregulated system.

Mandated vesting and the nondiscrimination rules substantially reduce the range of voluntary choice in retirement plan design.[272] By limiting voluntarism in retirement plan design, the combined regulatory regime greatly limits the extent to which an employer and its employees may tailor the compensation packages of different employees to satisfy their differing preferences for retirement benefits and other forms of compensation. In the long run, the regulatory regime has no effect upon the retirement benefits of short-tenure employees and non-highly compensated employees, but it reduces the benefits of long-tenure employees and highly compensated employees. These are the employees who value retirement benefits most highly. Since a plan is compelled to provide a lower level of benefits to the employees who prefer those benefits, the plan will add less value for the sponsoring employer and participants than it would have added in the absence of the legal mandates.[273] Since retirement plans generally will provide lesser value to sponsoring employers and plan participants, there will be a reduction in the number of plans and the level of re-

---

271 *See supra* note 212 and accompanying text.

272 In a voluntary retirement plan system, mandated vesting and its supporting rules create much more standardized retirement plans, more of a package deal. The employer and employees are faced with much more of a take-it or leave-it choice.

273 *See* IPPOLITO, *supra* note 57, at 177.

> Eliminating the regulatory burden on private pension plans confers economic efficiencies. First, firms will face lower direct administrative costs of enforcing discrimination rules. Second, low discounters will not face artificial restrictions on their savings rates (as in 401(k) plans) if others in the

tirement benefits provided by them. Regulation necessarily implies this reduction in the number of plans and the benefits provided by them.

Retirement plan regulation increasingly offers employers and employees a take-it or leave-it package deal. Narrower alternative choices about employee participation, vesting, accrual, and payment of benefits imply that fewer plans will offer value added for different employers and different workforces. When an employer and its employees desire to include retirement benefits as a part of employees' compensation, they must consider not only the employees who will voluntarily choose to save for retirement, but also the short-tenure employees and a sufficient number of non-highly compensated employees. If the plan cannot design coverage groups and benefit levels that will provide benefits that have a value to the entire group of participants which is at least equal to the after-tax cost of the benefits, then the plan will simply be "uneconomic." If the plan is previously existing, it will be terminated; if the employer and employees were considering retirement benefits, the design constraints imply that the plan will never be created.

As a matter of historic fact, the 1974 enactment of ERISA's intensive regulation of the retirement plan system coincided with a flattening of the growth of that system. In 1940, 15% of private sector workers were covered by a retirement plan; in 1970 the percentage of coverage peaked at 45%.[274] Since 1970 coverage has not expanded,

> firm do not wish to save. Third, pension firms will be allowed to craft their pension plans to attain the highest value added across their workforces.

Id.

274 Private retirement plan coverage peaked in 1970, and has subsequently declined.

Private Sector Pension Coverage:

Year	Private sector workers covered (%)	Full-time private sector workers covered (%)
1940	15 %	17 %
1945	19	21
1950	25	29
1955	32	37
1960	41	47
1965	43	49
1970	45	52
1979	43	50
1983	41	47
1988	42	48
1993	43	

SOURCE: Estimates for 1940–70 were calculated by Beller and Lawrence (1992) and include only nonagricultural workers. Estimates for 1979–93 are calculated from pension supplements to the Current Population Survey, and do not exclude agricultural employees.

and by many measures, it has declined; in 1993, only forty-three percent of workers were covered.[275] Of course many factors influence the expansion and contraction of retirement plan coverage, including the level of marginal income tax rates faced by participants, employment patterns by industry type, the fraction of the workforce that belongs to labor unions, needs and preferences for part-time and flexible time employment and for shorter-term and as-needed employment, and general economic conditions.[276] Nonetheless, the regulatory burden on private retirement plans is significant among the factors associated with changes in the private retirement plan system since 1974.[277] The regulatory burden can be quantified in one dimension: expanded regulation increases administrative costs incurred

---

DORSEY, *supra* note 81, at 16 (citing DANIEL J. BELLER & HELEN LAWRENCE, *Trends in Private Pension Plan Coverage, in* TRENDS IN PENSIONS (John Turner & Daniel Beller eds., U.S. Dept. of Labor 1992)); *see also* William E. Even & David A. Macpherson, *Why Did Male Pension Coverage Decline in the 1980's?*, 47 INDUS. & LAB. REL. REV. 439, 439 (1994) ("During the 1980's, pension coverage among men in the private sector labor force fell and real contributions to pension plans by private sector employers fell 36%."); Bloom, *supra* note 45, at 539.

> During the 1980's . . . the upward trend in pension coverage reversed itself. Household and establishment surveys provide evidence of modest to sizeable declines in the proportion of workers covered by pensions, with considerable variation across demographic groups. National income and product account data also reveal a sharp fall from 1980 to 1989 in the proportion of total employee compensation taking the form of employer contributions to retirement plans (from 5.8 percent to 3.9 percent. . . .).

Id.

Bloom and Freeman correlate about half of the decline in pension coverage with the fall in unionization, decline in real earnings, and to lesser degrees, changes in industry, occupation, firm size and other employee factors. They have no empirical explanation for the remaining half of the coverage decline. While they believe that the regulatory burden has increased the costs of retirement plan sponsorship, they do not believe that there is a theoretical reason why increased costs would be an important factor in explaining the fall in pension coverage. *See id.* at 542, 543; *see also* MCDONNELL, *supra* note 5, at 81.

> Employment-based retirement and savings plan participation among full-time employees has fallen in recent years. In 1986, 91% of all full-time workers in medium and large establishments participated in a retirement or other savings plan, compared with 78% in 1993. Likewise, participation rates among full-time employees of small private establishments fell from 47% in 1992 to 42% in 1994.

Id. (citations omitted).

275 *See* BELLER & LAWERENCE, *supra* note 274.

276 *See generally* Bloom, *supra* note 45, at 542–44; Even & Macpherson, *supra* note 274, at 539–45.

277 The oft-cited *Report of the N.Y. State Bar Ass'n Special Comm. on Pension Simplification* concluded,

by retirement plans. Data demonstrate that the administrative costs of retirement plan sponsorship have increased substantially since 1974, particularly for plans with fewer than 100 participants and for defined benefit plans.[278] Apart from financially measurable administrative costs, the regulatory burden consumes a sponsoring employer's time and attention. These added costs decrease the value of retirement plan sponsorship, which suppresses plan coverage.[279]

The regulatory burden is particularly problematic for small employers, those employing fewer than 100 employees.[280] This group of employers is very significant; it employs about forty-one percent of all private-sector wage and salary workers.[281] There is a substantial gap in retirement plan coverage between small and large employers:

Employer size	Participation rate*
Fewer than 25 workers	15.4%
25-99 workers	36.0
100 or more workers	66.2

*Percentage of all workers participating in an employer-sponsored plan[282]

The most important reason for this low coverage is that these employees prefer wages and other forms of fringe benefits to retirement benefits, but the second most significant reason is the regulatory burden on a small employer's retirement plan.[283] Interestingly, among other reasons for not sponsoring a retirement plan that were specifi-

> The legislative process by which the federal regulation of pensions has developed . . . has produced a body of law that is both too complicated and too changing. . . . The process must be halted lest the private pension system be destroyed, with devastating results for the retirement security of the Nation's workers and their families.

ALVIN D. LURIE, N.Y. BAR ASS'N, REPORT OF THE SPECIAL COMMITTEE ON PENSION SIMPLIFICATION, *reprinted in* 8 AM. J. TAX POL'Y 75, 75 (1998).

278 *See* MCGILL ET AL., *supra* note 164, at 355–58; KELLY OLSEN & JACK VAN DERHEI, DEFINED CONTRIBUTION PLAN DOMINANCE GROWS ACROSS SECTORS AND EMPLOYER SIZES, WHILE MEGA DEFINED BENEFIT PLANS REMAIN STRONG: WHERE WE ARE AND WHERE WE ARE GOING 13–14 (Employee Benefit Research Institute Issue Brief No. 190, Oct. 1997).

279 Professor Zelinsky has suggested that as much as 50% of the decline in retirement plan participation during the 1980s can be reasonably attributed to the regulatory burden. *See* Zelinsky, *Tax Policy*, *supra* note 41, at 597.

280 *See* PAUL YAKOBOSKI & PAMELA OSTUW, SMALL EMPLOYERS AND THE CHALLENGE OF SPONSORING A RETIREMENT PLAN: RESULTS OF THE 1998 SMALL EMPLOYER RETIREMENT SURVEY 3 (Employee Benefit Research Institute Issue Brief No. 202, Feb. 1998).

281 *See id.*

282 *Id.*

283 *See id.* at 6–7.

cally cited by small employers, forty-two percent mentioned the vesting requirements and the resulting larger fraction of plan contributions being paid to short-tenure employees.[284] For this large group of potential retirement plan sponsors, retirement plan regulation, particularly the mandated vesting regime and the nondiscrimination rules, provide a powerful explanation for the omission of retirement benefits from the employees' compensation packages.

V. Some Policy Implications

A. *Can Voluntary Retirement Plans and Mandated Vesting Coexist?*

Our voluntary private retirement plan system can and does coexist with mandated vesting. The system has been subject to mandated vesting for twenty-five years, yet there are still 702,000 voluntary private retirement plans providing retirement benefits to about forty-three percent of private sector workers. However, the retirement plan system is very different than it would be if mandated vesting had never been enacted. Mandated vesting probably has reduced the fraction of workers covered by private retirement plans and the benefits that long-tenure employees receive.

Mandated vesting has little effect upon the benefits of short-tenure employees because of the voluntary nature of private retirement plan sponsorship. Mandated vesting cannot and does not increase the retirement benefits of the short-tenure employees, who are the intended beneficiaries of the mandate. The cost of mandated retirement benefits must be shifted to the short-tenure employees by means of reductions in wages. But short-tenure employees generally are unwilling to accept retirement benefits in lieu of wages. Since retirement plan sponsorship is voluntary, and the level of benefits provided is voluntary, retirement plans respond to mandated vesting by reducing the level of benefits that accrue for short-tenure employees. This response returns retirement benefits for short-tenure employees to approximately the level that existed prior to the mandate.

In the long run, in the absence of mandated vesting, more employees would be covered by retirement plans, and long-tenure employees would receive larger retirement benefits. Mandated vesting constrains the flexibility of retirement plan design to provide retirement benefits to those employees who value the benefits most highly, the long-tenure employees. Fewer retirement plans can be created or continued that will provide benefits to employees who value the benefits at least as highly as the wages that they must forego to pay for the

284 *See id.* at 6.

benefits. Since fewer plans are sponsored, a smaller fraction of workers is covered than would be the case in the absence of mandated vesting. The plans that can be continued in the face of the mandate are pushed toward providing only that level of retirement benefits that will be acceptable to short-tenure employees. This is a lower level of benefits than long-tenure employees would choose. If the constraints of mandated vesting were removed, the level of benefits provided to long-tenure employees would increase.

Mandated vesting is a destructive policy when measured against its effect on aggregate retirement benefits. The retirement benefits of short-tenure employees are not enhanced, but plan coverage is suppressed, and the benefits of long-tenure employees are reduced. If aggregate retirement benefits were the only standard, the conclusion would be clear: mandated vesting should be repealed, and retirement plan vesting should be deregulated.

B. *Should Retirement Plan Vesting Be Deregulated?*

It is premature to conclude that mandated vesting should be repealed. Mandated vesting cannot be judged solely by its effects upon aggregate retirement benefits. There are at least two other important justifications for regulation of vesting. If one makes the (very dubious) assumption that the nondiscrimination regime deserves to be sustained or improved, then regulation of vesting may be justified as a necessary element of that regime. And regulation of vesting may be necessary to achieve an acceptable level of protection of employee interests in retirement benefits.

The nondiscrimination regime attempts to channel some portion of a retirement plan's tax subsidy toward payment of the costs of benefits for non-highly compensated employees. It does this by requiring a plan to accrue benefits for non-highly compensated employees that are reasonably comparable to the benefits accrued for highly compensated employees. However, in order for non-highly compensated employees to actually receive retirement benefits, these employees must achieve some degree of vesting under the plan. (In the absence of vesting, all of the benefits of non-highly compensated employees could be forfeited and reallocated to highly compensated employees.) The current nondiscrimination regime essentially assumes that the present vesting mandates provide sufficiently nondiscriminatory benefits to non-highly compensated employees. If the regulation of vesting periods were substantially relaxed, some plans would adopt longer-deferred vesting. In order to avoid discrimination in benefits actually paid out, it would be necessary either to regulate vesting as a distinct subject within the nondiscrimination regime, or alternatively, to broaden nondiscrimination testing to include testing of benefits actually received by non-highly compensated employees.

However, the nondiscrimination norm as presently implemented cannot provide a logical or coherent justification for mandated vesting. The present nondiscrimination regime does not systematically channel the tax subsidy to non-highly compensated employees. The effect of the nondiscrimination regime on any given retirement plan depends upon the proportions of highly and non-highly compensated employees participating in that plan. The operation of the nondiscrimination regime is disconnected from its intended purposes. Since the present nondiscrimination regime is itself dubious, it cannot provide a sound justification for mandated vesting.

Mandated vesting might also be justified as necessary to achieve a minimum level of employee security in retirement benefits. This can be understood as a form of consumer protection, and the arguments might run in the following directions: workers need to be protected from accepting retirement benefits that turn out to be illusory, fraudulent, or excessively vulnerable to employer abuse; retirement benefits that remain forfeitable for some excessively long period are unreasonably dangerous to the financial health of employees, and should be outlawed. These concerns might support some regulation of vesting. And there are certainly reasoned explanations to be made for the full range of possible vesting rules. Immediate full vesting might be mandated on grounds that any period of forfeitability creates a significant danger to employees, and that no material social advantages are offered by forfeitable retirement benefits. At the other extreme, unregulated vesting might be justified on grounds that it will provide a wider range of choice to employers and employees, who will then choose forms of retirement benefits that maximize their mutual welfare. The best choice of vesting rules probably lies somewhere between these polar positions; it is unclear what that choice should be. But wherever choice of mandated vesting rules is made, one must never lose sight of the fact that regulation of vesting will necessarily suppress the total amount of retirement benefits provided by a voluntary retirement plan system.

Perhaps the typical patterns of job tenures have something to teach us about retirement plan vesting. During the job-shopping phase of their careers, younger workers are likely to sample several jobs with tenures as short as three or four years. Little is gained from mandating vesting for job-shoppers. (In that vein, little is gained by requiring retirement plan participation for job-shoppers.) After job shopping, workers settle into a job that typically will last fifteen years or more; obviously most workers can have, at most, two such long-tenure jobs. If vesting is to be regulated (and the case for regulation remains unproven), a worker with at least fifteen years of service should be covered by mandated vesting. Perhaps the initial version of mandated vesting enacted in ERISA—vesting after fifteen years of service—reflects a sounder policy. And perhaps the last twenty-five years of incremental acceleration of vesting reflect politicians' needs for short-term "accomplishments" rather than reasoned judgments about the best interests of American workers.

CONCLUSION

There is a strong theoretical case suggesting that mandated vesting suppresses the provision of retirement benefits in our voluntary retirement plan system. Empirical data is consistent with this theory. This conjunction of theory and fact raises a prima facie case for the exercise of caution before another increment of mandated vesting is imposed on the private retirement plan system. Proponents of mandated vesting should sustain a burden of persuasion that further acceleration of retirement plan vesting will in fact improve the availability, security, or magnitude of retirement benefits of workers generally.