The Foundation for Enterprise Development

Retirement Security and Employee Ownership: Policy Reform After Enron

February 15, 2002 • San Diego, California

Introduction

This much is known: on December 2, 2001, Enron Corporation filed for Chapter 11 bankruptcy, the largest bankruptcy petition in U.S. history, wiping out shareholder investment that had once been valued at more than $60 billion.

Many of Enron's employees had held substantial amounts of Enron stock in the company's retirement savings plans. As a result, they saw the value of their retirement savings first expand dramatically and then plummet even more suddenly as the Enron story played out.

In the aftermath of the collapse, compelling questions have been raised about the cause of the Enron debacle. Actions and events that led to the company's collapse are still being pieced together. Responsibility for the losses suffered by Enron's investors has been laid to the company's executive management, its board of directors, its auditors and the Securities and Exchange Commission. The law governing company-sponsored retirement plans has also been called into question in connection with the retirement plan losses suffered by Enron employees. Some have challenged the wisdom and advisability of employee investment in the stock of their employer.

A Meeting of Thought Leaders

The Foundation for Enterprise Development (FED) is a non-profit corporation dedicated to advancing the use of entrepreneurial employee ownership worldwide as a positive strategy for creating high-performing organizations. To evaluate the Enron failure and its ramifications, especially with regard to what it might mean for the principles and practice of entrepreneurial employee ownership, FED called together leaders in business management and employee stock ownership from across the country. Recently, eighteen experts in pension and retirement programs, law, finance, accounting and corporate management convened in a "Thought Leader Session" to discuss and assess the ramifications of the Enron situation.

This paper sets forth the observations, conclusions and recommendations that emerged from the Thought Leader discussion. It is the intention of FED that this work contribute to the public and legislative discussion and, most importantly, assure that the great benefits of employee ownership – to employees, to companies and to this nation and others – are not lost or forgotten in the clamor to respond.

For more information on this issue and employee ownership in general, visit the FED's Web site at www.fed.org.

What Caused Enron's Collapse?

The information available to the Thought Leader group suggests that responsibility for Enron's unexpected demise can be apportioned among a large and diverse group of individuals and institutions. Factors that appear to have contributed to Enron's collapse include:

1. Compensation systems that failed to align management interests with those of long-term investors.

The compensation packages created for management provided equity interests that they could use to achieve personal gain relatively quickly, without assuring shareholder value over the long term. Enron's management, therefore, pursued a strategy that, while putting the company's long-term prospects at risk, was effective in driving up its share price over the short term.

2. An executive management team driven by greed.

Management drove up the company's share price over the short term with techniques ranging from misleading accounting practices that misrepresented the actual profitability of the company to investor relations campaigns that sought to reposition the perception of Enron from an old economy energy distributor to a "new economy" technology-driven trader of energy and other commodities. Executives then profited by selling more than 1.75 million shares, valued at more than $1 billion, at prices ranging from $80 down to $40. The lack of congruence between Enron's published financial statements and its actual financial condition was not, it appears, merely a matter of accounting technicalities. Rather, the misrepresentation of the true state of affairs appears to have been a deliberate strategy of Enron's management and a product of fraud and dishonesty.

3. Failure of the Board of Directors to carry out its oversight responsibilities.

The watchdogs, it seems, were lapdogs. A corporate board of directors has a fiduciary duty to the company's shareholders to see that the company is managed in the best interests of those shareholders. It is not yet clear what they knew or when they knew it, but it appears there are only two possibilities: the Board was either negligently ignorant of what management was doing, or was complicit in misleading investors.

4. Lack of scrutiny on the part of the company's auditors.

Investors rely on the accounting firm that audits a company's financial statements to protect against the production of financial statements that misrepresent the company's financial condition and the results of operations. Many investors feel that, perhaps because of a too-cozy relationship with Enron, the company's auditors (the firm formerly known as Arthur Andersen, now doing business as Andersen), signed off on financial statements that in fact dramatically misrepresented the financial condition of the company. Many see the need to restate four years of earnings as an implied admission on the auditing firm's part that the accounting methods used by Enron were not appropriate. Thought Leader meeting participants with professional backgrounds in accounting noted, however, that it was possible management misled the auditors and that auditors can only audit and verify numbers provided by the company.

5. Wall Street's great desire for investment banking fees and higher stock and bond prices.

Enron produced huge consulting fees for the investment banks involved in its merger and acquisition program and enormous wealth for institutional investors as its equity price rose. The financial media serving Wall Street repeatedly glorified Enron's growth and success, helping publicize and support the company's rising stock price, without sufficiently researching the company.

6. A crisis of confidence that management could do nothing to reverse.

Enron's unraveling began with a seemingly isolated 20% write-down in the company's earnings. Within weeks, however, the company had reached the point that it had to file for bankruptcy. With the write-down, the faith of investors in the rosy picture that Enron had painted was shaken, and management was unable to convince investors the company's problems could be fixed. The resignation of CEO Jeffrey Skilling in August for "personal reasons" only heightened the growing crisis in investor confidence. Once it was clear there were serious financial irregularities, institutional investors abandoned the stock and Enron's bank credit dried up. The drop in the company's equity price triggered the need for debt payments that Enron could not meet. Bankruptcy was the only protection from creditors.

What Are the Ramifications of Enron's Collapse for Employee Ownership?

As the facts of the Enron story are fully and finally brought out, and culpability for the damage assigned, the impact may be felt in a number of areas. Calls for reform – legislative, regulatory and policy – may well lead to new standards of accountability and oversight for America's public corporations, including changes in:

- Accounting standards and practices

- The role and methodology of the corporate audit
- Corporate governance and board of director accountability
- Securities and Exchange Commission enforcement authority

Beyond these areas that are immediately implicated, we may see ramifications in areas not as directly involved in the Enron debacle. Campaign finance reform efforts, for example, may take on new life in light of the disclosures of soft-money campaign contributions made by the managements of both Enron and Andersen, and allegations that government officials in both the administrative and legislative branches may have been influenced by those contributions. In contrast, proposals to change the nation's Social Security system by introducing an element of employee investment control may suffer a setback in light of the questionable investment decisions made by many Enron employees and the damaging losses they suffered to their retirement savings as a result.

The central focus of the Thought Leaders, however, was on the ramifications of the Enron debacle for the principles and practice of employee ownership. Already, media stories and commentators have highlighted the dramatic losses suffered by Enron employees who held varying amounts of Enron stock in the company's tax-qualified retirement programs. And legislators across the political spectrum have rushed to introduce measures that would amend the laws governing company-sponsored retirement plans. Ultimately, the deliberations of the Thought Leaders identified three areas in which the ramifications of the Enron experience for employee stock ownership may be profound.

1. The continuing development of employee ownership may be severely curtailed by legislation aimed principally at increasing the security of company-sponsored retirement savings plans.

Employee ownership has strengthened companies, improved productivity, driven innovation and sparked a dramatic expansion of the entrepreneurial spirit within workers across a wide range of companies and industries. It has also given millions of ordinary employees access to a level of capital ownership and personal wealth that would be unattainable without it. It has strengthened our free enterprise, capitalist system by giving millions of people a stake in it, and an appreciation of its benefits. It produces the ultimate "win-win" situation, in which individuals thrive, companies improve their performance, and our economy and society as a whole become healthier and more vital.

The great story of employee ownership, however, remains largely a well-kept secret. Many well-meaning policy makers continue to take a paternalistic view, seeing workers purely as wage earners, whose interests are largely adverse to those of their employers, and who require protection from their employers. The Thought Leaders shared great concern that the remarkable value of employee ownership may go unrecognized in the post-Enron public debate. As a result, Congress may ultimately enact measures that, while intended primarily to assure secure and diversified retirement savings, have the added effect of severely crippling the ability of companies to recognize their employees as key stakeholders and award them a share of corporate ownership.

Concerns about the likelihood of aggressive new regulatory legislation were heightened because of the publicity that has been accorded to the record of campaign contributions that flowed from Enron to the current Administration. Ordinarily, Republican politicians could be expected to oppose measures that would restrict employer discretion in the operation of retirement plans. But the ties between Enron's senior management and members of the Administration may leave Republicans (as well as Democrats) reluctant to oppose new regulatory measures for fear of being perceived as captives of major contributors.

2. There will be movement toward increased diversification of retirement savings.

The manner in which the retirement savings of Enron's employees were ultimately invested was determined (as with any employee-directed 401(k) program) by three parties: (1) the Federal Government, which establishes the basic structure of employer-sponsored retirement plans and sets outside limits on the terms of those plans; (2) the employer, which, within the limits established by Federal law, chooses the terms and rules by which its own plans will operate; and (3) the individual employees who, with the terms and rules established by the employer, make their investment choices.

The losses suffered by Enron employees who invested a large portion of their retirement assets in a single investment – Enron stock – may spur a range of reaction, all aimed at introducing more diversification into employer-sponsored retirement savings programs. These reactions may include the following:

- By the Federal Government, legislation that requires greater diversification and/or assures that employees will have the ability to diversify the assets in their employer-sponsored retirement plans;

- By employers, policies and practices that encourage or require their employees to diversify their retirement savings; and

- By employees, increased understanding of, and appreciation for, the value of diversification, with investment choices that reflect that appreciation.

To the extent that legislative actions and/or company policies are implemented with the aim of increasing diversification in retirement plan savings, such measures may take one or both of two forms: measures that *require* diversification (for example, a cap that prohibits investment of more than 20% of an employee's account in a single stock); and measures that *guarantee the opportunity* to diversify (such as, the elimination of employer rules requiring that some retirement plan assets be held in the form of company stock).

Depending on the particular form taken, legislative measures intended to assure greater diversification may have serious and unintended ramifications. For example, a law prohibiting companies from making their matching contributions in the form of company stock may result in many companies cutting back significantly on the dollar value of their matching contributions because of the large drain on company cash flow that would otherwise result. While such reductions would shrink the retirement savings of ordinary employees, company executives could, and no doubt would, continue to receive large contributions of company stock through executive deferred compensation programs and in other forms.

3. There will be action to encourage and improve education programs to inform employees about investment principles and practices.

A large portion of the Enron stock held by employees in their retirement accounts was there voluntarily. That is, employees were free under Enron's rules to liquidate that stock and invest in other assets, but chose to keep their money in company stock.

Like most companies, Enron provided no formal program of investment education to assist their employees in fulfilling their role under the Enron retirement savings program as their own investment advisor. A key reason for the almost complete absence of such employee education programs in America's major corporations can be found in the provisions of our pension law. Attorneys routinely advise their client companies that they risk exposure to liability under rules of the Employee Retirement Income Security Act of 1974 (ERISA) if they provide that service. Under ERISA's terms, a party who provides "investment advice" with regard to the investment of retirement plan money may be a fiduciary of the retirement plan and thus subject to potential fiduciary liability. Moreover, an employee who suffers investment losses after participating in an employer-provided investment education program might bring suit against the employer, claiming that the program was deficient in some respect and that the employer must therefore make up the losses. Ironically, under current law, an employer who provides no help at all to its employees, leaving them to flounder and perhaps commit serious investment blunders, runs no risk of liability, while a company that provides a thorough investment training program for its employees may incur large liabilities if, ultimately, some gap or flaw is found in the program.

In the absence of sound investment training and/or advice, many Enron employees were left to their own devices in managing the money in their Enron 401(k) account. In this vacuum, employees were no doubt greatly influenced by the track record of Enron's stock as its share price climbed impressively. They heard as well the rosy and enthusiastic representations of management about the great future that awaited the company. While these prognostications may have been standard management fare, aimed as usual at the investor community, they no doubt encouraged employees to invest in Enron stock, even as the price was falling and management was selling.

How Can Entrepreneurial Employee Ownership Be Preserved As Our Retirement Savings System Is Strengthened?

The ramifications of the Enron collapse may be profound. It may be a catalyst that stimulates changes in areas ranging from accounting and auditing standards to SEC enforcement to campaign finance rules. In this turbulent environment that holds both promise and perils, how can we assure that the tremendous benefits of employee ownership are preserved, even as policy makers within government and industry consider measures to improve retirement savings practices?

1. Understand the value that employee ownership brings to individuals, businesses and our nation as a whole.

Employee ownership has become an integral part of the American economy. More than ten million employees now receive stock options from their employer; more than fifteen million take part in company-subsidized employee stock purchase programs; and millions more participate in ESOPs and other ERISA regulated retirement programs in which they hold company stock. All told, more than half of all U.S. employees hold some form of equity stake in the company where they work.

Why is this important? Consider these reasons:

• *Improved business performance.* Research has shown repeatedly what most of us would intuitively expect: that when employees are co-owners of their company, they show more commitment, more determination, and generate better results. Consider a 1987 study by the National Center for Employee Ownership. It found that companies which had given employees stock through an ESOP and then empowered them to participate in deciding how to get the work done had a growth rate that was 8% to 11% higher than it would have been without ownership and participation. A recent Gallup poll of employees reported that 48% of respondents said they would work harder and more conscientiously if they had greater say in decisions relating to their work. These respondents were discouraged, however, by their belief that any increase in their output would only benefit someone else, such as management, customers or shareholders.

• *Greater wealth accumulation for employees.* Research has also demonstrated that employee ownership does, in fact, cut employees in on a greater share of the wealth that they produce through their efforts on the job. A 1998 study of more than 100 ESOP companies in the state of Washington found that employees at those companies had an average of $32,213 in their company-sponsored retirement accounts (including ESOP accounts), while employees at the comparison companies averaged about $12,735. Nor did this added retirement wealth come as a trade-off for giving up other compensation. In fact, the median hourly wage in the ESOP firms was 5% to 12% higher than the median hourly wage in the comparison companies. The study made clear that companies were providing the ESOP as an *additional* benefit, not as a substitute for other customarily granted programs.

The great technology boom of the 1990s created a vast amount of new wealth. Without employee ownership, that wealth would have been concentrated in the hands of just a small group. Because the companies in the technology sector regularly cut their employees in on a piece of the equity, however, that wealth was shared by millions of Americans. More importantly, that wealth was created largely *because* the technology sector workers were granted ownership stakes in their companies. The feverish creativity, innovation, long hours and dogged pursuit of success could not and would not have taken place had these workers been offered nothing more than a steady paycheck and a pension. Those companies knew what they were doing when they practiced employee ownership.

• *Enriched roles and status for employees.* Accumulating wealth is certainly an important goal. But it is not all there is to working life. When companies recognize their employees as key contributors by granting them a piece of company ownership, they are also granting meaning, citizenship and community. The power of employee ownership lies not only in its potential to generate productivity and build wealth, but in its ability to change the work lives of people. It signals partnership, and signals meaning. Employees begin to feel, think and act like owners, taking responsibility and pursuing opportunity. It is this power to create meaning and community that most distinguishes employee ownership from other company-provided benefit programs.

Quietly, organically, without big government programs, employee ownership is boosting our productivity, driving innovation, distributing well-earned wealth more broadly, and cutting workers in on the manifold benefits that come with being a co-owner. It has sparked a dramatic expansion of the entrepreneurial spirit within worker-owners across a wide range of companies and industries. Working people, long shut out of owning wealth-producing capital, are now taking on both the rights and the responsibilities of business ownership, and building significant capital estates along the way. Employee ownership is breaking down the age-old barriers that long bifurcated us into an elite owning class and a class that worked, giving more and more Americans a meaningful stake in our economic system.

2. Recognize the clear distinction between employee ownership and retirement savings – and label employer-sponsored programs accordingly.

Employee stock ownership and retirement saving are two separate and distinct goals. And government and industry policy makers are unlikely to achieve a positive resolution of the issues raised by the Enron situation unless they grasp this distinction.

Clearly, each is valuable. Moreover, they often bear a close relationship; it is possible, to some degree, to pursue both goals at the same time through the same vehicle. Still, no one should lose sight of the fact that the two goals are separate and distinct. In investing for retirement, the goal is simply to amass a secure and ample fund for the employee's support and enjoyment in retirement. The risk of uncertain investment returns, therefore, is something to be minimized. In contrast, the cornerstone of employee ownership is that employees will benefit according to the success of the company. Investing in the company's future – with exposure both to the opportunity to accumulate wealth and the risk that the business could fail – is not only acceptable, but desirable in an employee ownership program.

Employer-sponsored plans that are intended as retirement savings programs should be clearly labeled as such and regulated as such. Likewise, employer-sponsored plans that are intended to create employee ownership should be clearly labeled, and left free of regulatory requirements (such as diversification standards) that may be appropriate only for retirement plans. There should be no surprises for the participating employees.

3. Protect employee freedom of choice.

Our nation's system of employer-sponsored retirement programs has successfully amassed trillions of dollars in employee retirement savings – much of it in the form of employee-directed 401(k) savings accounts. These accounts have been premised on the principle of employee control – the freedom of employees to determine what investment approach best matches their personal goals.

Individuals find themselves situated in circumstances that differ dramatically from one another. Some are young, some are old. Some, in addition to their employee-directed 401(k) plan, enjoy the government-guaranteed retirement security of a defined benefit pension plan, while others don't. Some have spouses with retirement savings programs of their own. Some have little else in the way of retirement savings other than the plan, and will need to count on it. Others have ample additional retirement savings (they may have IRA accounts, retirement accounts with previous employers, inheritance, or any number of other sources) and want to invest aggressively in the hope of producing a major gain to add to their existing savings. No single approach to retirement plan investment can meet the needs of all employees. Employees are entitled to the freedom to invest *their* savings in the manner that they determine.

Proposals that *preserve, secure and expand* employees' ability to more effectively control the investment of their retirement assets – for example, proposals that would prohibit employers from forcing employees to hold their retirement plan assets in employer stock (or in any other particular investment) deserve a place at the table for serious consideration. In contrast, proposals that would *take away* employees' freedom to determine how they will invest are misguided. Legislating controls on what employees may choose for their retirement investments, such as a percentage cap on the amount of employer stock that an employee may hold in a retirement account, would clearly restrict employee freedom.

4. Protect and enhance employee retirement savings.

Just as proposals that preserve and strengthen employee freedom of choice should be viewed constructively, so should proposals that protect and enhance the ability of American employees to amass ample and secure retirement savings as they work. Consider, for example, the following proposal:

The 3% Safe Harbor. Current law provides a "Safe Harbor" that exempts a 401(k) plan from the usual "discrimination" testing (highly paid employees versus other employees) if the employer makes a contribution of at least 3% of employees' pay to the retirement savings accounts of all eligible employees. This "3% safe harbor" could be extended so that employers who make a minimum cash contribution of 3% of pay to all eligible employees would be exempt from any new rules that might otherwise restrict the ability of employers to make matching contributions of company stock – and the ability of employees to invest their account balances as they see fit.

5. Increase employee education.

If employees are to manage their investment responsibilities under 401(k) plans successfully, they must have an understanding of sound investment concepts, principles and practices. Efforts to improve the security of employee retirement savings after Enron, therefore, must assure that employees will receive the kind of educational content that is necessary for the competent management of their responsibilities under employee-directed retirement plans. Both employers and independent service providers, however, fear that the delivery of educational content could later be construed as the giving of "advice," thus exposing the providers to fiduciary liability under ERISA. Legislation should therefore be considered that would protect employers by clearly and simply defining the parameters of educational training efforts that will not constitute "investment advice" under ERISA.

Conclusion

In the wake of the Enron bankruptcy, changes of policy and practice will undoubtedly follow. Such changes may be effected through legislative action by the federal government, through policy modifications made by employers (who, within the parameters established by law, determine the terms and rules of their retirement savings programs), through behavioral changes of employees (who may alter past investment strategies), or a combination of these. By gathering together a group of nationally recognized experts in both retirement savings and employee ownership and convening these participants in a Thought Leader session, the Foundation for Enterprise Development has sought to advance public discussion and understanding of these challenging issues.

Employee ownership is one of the fundamental strengths of the American free enterprise system. It has become essential to an entrepreneurial business environment, which gives U.S. businesses a competitive edge, rewards our workforce for their efforts, and contributes to our nation's prosperity. It is important, therefore, that any response to the events at Enron be the result of thoughtful and careful deliberation rather than a rush to "do something."

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January 2002
San Diego, California

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