# THE ESOP AT THIRTY: A DEMOCRATIC PERSPECTIVE

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## I. INTRODUCTION

A central irony of the ESOP,[1] thirty years after its recognition in the Employee Retirement Income Security Act of 1974, is that it has succeeded best where it has been used in participatory ways for which it was never intended and is poorly designed. This fact, well attested to by a body of empirical data, presents the question: How can the ESOP, or an alternative thereto, be better adapted to democratic uses? The inquiry takes us away from the grandiose expectations of the original ESOP sponsors and present-day proponents of "shared capitalism"[2] and leads instead to a recasting of the legislative scheme to recognize and encourage the modest role played by democratic employee ownership in American business.

### A. *History of the ESOP*

Employee stock ownership appeared early in the history of the modern corporation in the United States.[3] By mid-1927, there were approximately 800,000 employee shareholders with aggregate holdings equal to approximately 1% of all corporate stock.[4] After falling into disrepute in the stock market crash of 1929,[5] it began to reemerge

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1. This is the commonly used acronym for the form of employee stock ownership known by the generic name, Employee Stock Ownership Plan.

2. *See*, *e.g*., JOSEPH BLASI ET AL., IN THE COMPANY OF OWNERS (2003); JEFF GATES, THE OWNERSHIP SOLUTION, TOWARD A SHARED CAPITALISM FOR THE TWENTY-FIRST CENTURY (1998).

3. Rand, McNally and Co. instituted the first formal employee stock ownership plan in 1879. Richard L. Doernberg & Jonathan R. Macey, *ESOPs and Economic Distortion*, 23 HARV. J. ON LEGIS. 103, 105 n.11 (1986). By 1919, eighty-nine companies had adopted such plans; their popularity then surged for a period of years in the 1920s. ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 58 (1939).

4. BERLE & MEANS, *supra* note 3, at 59.

5. JOHN LOGUE & JACQUELYN YATES, THE REAL WORLD OF EMPLOYEE OWNERSHIP 8

in the post-war era as companies adopted employee stock purchase plans and stock bonus plans, a form of retirement plan funded by employer stock.[6] But the recognition of ESOPs as a favored form of stock bonus plan in the Employee Retirement Income Security Act of 1974 (ERISA) was the watershed event that led to the proliferation of employee stock ownership plans, including not only ESOPs but also stock options, stock purchase plans, and the now-notorious investment of employer stock in 401(k) plans.[7]

The ESOP legislation in 1974 was the product of the peculiar chemistry between the eccentric economic theories of Louis Kelso and the conservative populism of Senator Russell Long, chairman of the Senate Finance Committee from 1966 to 1981 and an influential member of the committee until his retirement in 1986.[8] A securities lawyer with a prominent San Francisco law firm, Kelso developed an elaborate body of economic theory that he saw as a challenge to conventional economics and the key to the survival of capitalism.[9] In his view, capitalism was afflicted with two related pathologies—the increasing concentration of capital in a small fraction of the population and the high level of taxation that took income from productive members of society and distributed it to the nonproductive. The heart of the problem, as Kelso saw it, lay in traditional capital financing methods that conditioned the acquisition of new capital on the ownership of existing capital, thus creating a "spiraling concentration" of capital ownership and providing the political incentive for the New Deal wel-

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(2001).

6. A 1966 survey revealed that one-fifth of the firms on the New York Stock Exchange had employee stock purchase plans and an increasing number of firms were adopting stock bonus plans recognized by the Internal Revenue Code of 1954. *See* I.R.C. § 401(a) (1954); CONGRESSIONAL RESEARCH SERVICE, EMPLOYEE STOCK OWNERSHIP PLANS: CURRENT STATUS AND PROPOSED LEGISLATION, *reprinted in* HEARINGS BEFORE JOINT ECONOMIC COMMITTEE, 94th Cong., 1st Sess., at 12 (1975). Sears Roebuck and Proctor & Gamble pioneered the use of stock bonus plans, which first received tax-favored status in the Revenue Act of 1921. *See* Margaret M. Blair et al., *Employee Ownership: An Unstable Form or a Stabilizing Force?, in* THE NEW RELATIONSHIP, HUMAN CAPITAL IN THE AMERICAN CORPORATION 241, 249 (Margaret M. Blair & Thomas A. Kochan eds., 2000); Jared Kaplan, *ESOP's Fable, A Tale of Tax Planning Pitfalls and Opportunities Associated with Employee Stock Ownership Plans, Complete with a Choice of Morals*, 53 TAXES 898, 899 (1975).

7. The National Center for Employee Ownership (NCEO) has published useful surveys of these forms of employee stock ownership. *See* EMPLOYEE STOCK PURCHASE PLANS (Ed Carberry & Scott Rodrick eds., 2000); SECTION 401(K) PLANS AND EMPLOYEE OWNERSHIP (Scott S. Rodrick ed., 1997); THE STOCK OPTIONS BOOK (Scott S. Rodrick ed., 1997).

8. LOGUE & YATES, *supra* note 5, at 11-12.

9. *See* LOUIS O. KELSO & MORTIMER J. ADLER, THE CAPITALIST MANIFESTO (1958).

fare legislation.[10] The solution, he argued, was to restructure the financing of capital acquisition so that the ordinary worker could secure a capital estate and enjoy a second income from capital ownership.[11] Such a debt-generated redistribution of capital ownership would revitalize capitalism by making the ordinary worker a capitalist.

Kelso's search for a "program of financing new capitalists" led him to devise and advocate employee investment plans, backed by the sponsoring employer's credit, which could borrow money to finance investment through the purchase of the employer's stock.[12] As the employer paid off the loan, the employees would become beneficial owners of stock allocated to their account in the investment plan. He crafted the first of these plans in 1957 for Peninsula Newspapers, Inc., a small publishing business near San Francisco, but the concept spread slowly.[13]

In 1973, Kelso gained the ear of Senator Russell Long, the son of the famous Louisiana populist, Huey Long, who was then the conservative chairman of the Senate Finance Committee. The encounter proved to be Senator Long's revelation on the road to Damascus. In a late dinner at a Washington hotel, Kelso explained his vision of expanding capital ownership by giving ordinary workers access to self-liquidating debt.[14] According to Kelso, Long asked, "Are you saying that [these financing methods] can make haves out of have-nots without taking it away from the haves?" Kelso answered affirmatively. Long concluded, "That's the kind of populism I can buy."[15] Long never wavered from the conviction that he had found the key to reconciling capitalism with his populist origins. When introducing a bill ten years later, he explained: "The goal is to provide incentives for financing to be structured in such a way that, in the future, more Americans will have a chance to accumulate a capital estate."[16]

Long's conversion came at a critical moment in legislative history. The Senate staff was then developing a comprehensive revision

10. *See* LOUIS O. KELSO & MORTIMER J. ADLER, THE NEW CAPITALISTS, A PROPOSAL TO FREE ECONOMIC GROWTH FROM THE SLAVERY OF SAVINGS 28-32, 39-42 (1961); LOUIS KELSO & PATRICIA HETTER, HOW TO TURN EIGHTY MILLION WORKERS INTO CAPITALISTS ON BORROWED MONEY 18-39 (1967).

11. KELSO & HETTER, *supra* note 10, at 67-68.

12. KELSO & ADLER, *supra* note 9, at 240.

13. *See* Doernberg & Macey, *supra* note 3, at 107.

14. GATES, *supra* note 2, at 80-81; LOGUE & YATES, *supra* note 5, at 11-12.

15. Rudy Maxa, *Can We All Own a Piece of the Rock?*, WASH. POST, Dec. 10, 1978, at 5.

16. 129 CONG. REC. 33813 (1983).

of employee benefit law that would become ERISA. Kelso argued that the proposed legislation presented a practical opportunity to engraft his financing scheme onto the existing statutory authorization for stock bonus plans.[17] The statutory authorization for the ESOP appeared as one of several exemptions to the prohibited transaction rules of the legislation.[18] ERISA section 408, subdivision (b)(3), provides that the rules barring undiversified investment and self-dealing between employer and benefit plans do not apply to an employer's "loan to an employee stock ownership plan," which is defined as a stock bonus plan designed to invest primarily in qualifying employer securities.[19]

In the next decade, Senator Long secured the passage of some twenty-five bills promoting and elaborating upon this original ESOP legislation.[20] The body of ESOP legislation was the chief monument to his career in the Senate.[21] It is often an illusion, of course, to attribute the evolution of the law to the influence of individuals. The ESOP legislation also rode the crest of rising popularity of employee stock ownership that took other forms and some twelve states passed legislation encouraging ESOPs independently of Senator Long's influence.[22] Nevertheless the impact of Senator Long's conversion to Kelso's economic theories is visible in the curious classification of the ESOP as a retirement plan, in the generous tax benefits to encourage adoption of the plans, and probably, in the undemocratic structure of the ESOP legislative scheme.

17. The origins of the ESOP legislation in Kelso's economic theories have been discussed frequently and documented amply elsewhere. *See, e.g.*, D. Bret Carlson, *ESOP and Universal Capitalism*, 31 TAX L. REV. 289, 289-93 (1976); Ezra S. Field, *Money for Nothing and Leverage for Free: The Politics and History of the Leveraged ESOP Tax Subsidy*, 97 COLUM. L. REV. 740, 748-50; Michael W. Melton, *Demythologizing ESOPs*, 45 TAX L. REV. 363, 363-68 (1990).

18. The prohibited transactions rules of ERISA sections 406 and 407, among other things, generally restrict investments in employer securities to 10% of the fair market value of the assets of the plan. *See* ERISA §§ 406(a)(1)(E), 407(a)(3), 29 U.S.C. §§ 1106(a)(1)(E), 1107(a)(3) (1998).

19. *See* ERISA §§ 407(d)(6), 408(b)(3), 29 U.S.C. §§ 1107(d)(6), 1108(b)(3). *See also* I.R.C. § 4975(d)(3), (e)(7) (2002).

20. *See* GATES, *supra* note 2, at 53.

21. *See* JOSEPH RAPHAEL BLASI, EMPLOYEE OWNERSHIP, REVOLUTION OR RIPOFF? 7, 18-26 (1988); Frederick Ungeheuer, *They Own the Place*, TIME, Feb. 6, 1989, at 51.

22. *See* William R. Levin, *The False Promise of Worker Capitalism: Congress and the Leveraged Employee Stock Ownership Plan*, 95 YALE L.J. 148, 149-50, 150 n.7 (1985); Stanley R. Pietruska III, *ESOPs: Corporate Advantages Put Taxpayers at a Disadvantage*, 23 W. ST. U. L. REV. 53, 60-61 (1995).

Following Kelso's views,[23] Senator Long saw the ESOP as a vehicle for broadening capital ownership, not a means of achieving industrial democracy. While the Revenue Act of 1978 gave employees certain limited voting rights to their trust accounts,[24] he opposed any extension of these rights on the ground that it would discourage adoption of ESOPs.[25] The ESOP provisions engrafted on ERISA place control of employer stock in the hands of a trustee who is ordinarily appointed by the employer's board of directors.[26] During their employment, employees enjoy only a beneficial ownership in the employer stock, shorn of ordinary shareholder rights;[27] and upon retirement or severance of employment, they receive a distribution of their individual accounts either in stock or cash.[28] Some ESOPs involving direct contributions of stock to the trust represent a minor variation on the stock bonus plans pre-dating ERISA. But leveraged ESOPs, which link employee rights to repayment of the initial financing, have come to dominate the field.[29] The trust purchases the stock by a bank

23. Kelso formed an investment banking company, Kelso & Co., which put together many ESOP transactions. Field, *supra* note 17, at 749. The firm promoted its ability to design ESOPs without changing corporate control. Kelso's associate, Joseph Schuchert, asserted, "Our programs are the antithesis of workplace democracy . . . . We've been criticized for not giving workers more participation, but we believe workers are natural shareholders, not natural managers." Michael Hiltzik, *Employee Stock Plans Turn into Management Boon*, BOSTON GLOBE, Jan. 2, 1985, *quoted in* DAVID P. ELLERMAN, THE DEMOCRATIC WORKER-OWNED FIRM, A NEW MODEL FOR THE EAST AND WEST 105 (1990). Kelso charged that the use of employee ownership to give employees a voice in the corporate decisions would lead to "amateur management." *See* John Hoerr & Keith H. Hammonds, *Congress is Forming Battle Lines over ESOPs*, BUS. WEEK, Aug. 8, 1988, at 61-62.

24. Revenue Act of 1978, Pub. L. No. 95-600, §§ 141, 143, 92 Stat. 2788, 2796 (1978). For a discussion of voting rights, see *infra* text accompanying notes **Error! Bookmark not defined.-Error! Bookmark not defined.**.

25. Russell Long, Letter to Editor, BUS. WEEK, Sept. 12, 1988, at 6 ("Then, when some businessperson wants to share some of his good fortune with workers by vesting stock in them, BUSINESS WEEK would propose to keep it from happening by insisting that the employees have more voice in management than that generous person might be willing to share.").

26. ERISA § 403(a), 29 U.S.C. 1103(a) (1998).

27. *See* James G. Steiker, *ESOP Participants and Shareholder Rights,* 6 J. EMP. OWNERSHIP L. & FIN., No. 4, 43 (1994).

28. I.R.C. § 409(c), (o). For a comprehensive and reliable text on ESOP statutory and regulatory law, see 1 MICHAEL J. CANAN, QUALIFIED RETIREMENT PLANS § 3.31 to 3.42 (2004 ed.). *See also* 1 JEFFREY D. MAMORSKY, EMPLOYEE BENEFITS LAW, ERISA AND BEYOND §§ 2.04, 3A.01(2)(d), at 2-27 to 2-39, 3A-12.11 to 3A-26 (2004); Henry C. Blackiston III et al., *ESOPs: What They Are and How They Work*, 45 BUS. LAW. 85 (1989).

29. A 1992-1993 survey revealed that 57.9% of the ESOPs in Ohio were leveraged. *See* LOGUE & YATES, *supra* note 5, at 196. Leveraged ESOPs are the only vehicle for the potentially significant uses to purchase stock from a retiring owner or to carry out an employee buyout—two of the most important uses of the plans.

loan guaranteed by the employer or by a direct loan from the employer.[30] Then, as the loan is paid off, the employees' beneficial interest in the trust is allocated to their individual accounts.[31]

From its inception, the recognition of the ESOP as a stock bonus plan entailed a favorable tax consequence that served Kelso's vision of a new financing device to broaden capital ownership—it allowed the employer to pay off the ESOP loan with deductible contributions to the ESOP trust.[32] The effect, as now codified, is to give the employer access to funds through a sale of stock to the ESOP, which are financed by a uniquely tax-advantaged loan in which principal as well as interest payments are tax deductible.[33] During the last twelve years of Long's Senate career, Congress enacted a medley of additional tax incentives for ESOPs.[34] Congress later repealed some of these tax breaks, including tax credits, an estate tax deduction, and tax exclusion on interest from ESOP loans,[35] but the ESOP remains highly tax-favored. It enjoys the tax benefits available generally to qualified retirement plans: deduction of employer contributions to the plan,[36] exemption of trust from taxation on earnings,[37] and employee tax deferrals upon ultimate distribution of their individual accounts.[38] In addition, the tax code allows employers to deduct payment of dividends to stock held by an ESOP[39] and promotes the use of ESOPs as an estate-planning device for retiring business owners by allowing a deferral of gain on the sale of qualified securities to the ESOP trust.[40]

30. CANAN, *supra* note 28, § 3.35.

31. Treas.Reg. § 54.4975-11(c), (d)(2) (as amended in 1979).

32. *See* Charles A. Pillsbury, Note, *Employee Stock Ownership Plans: A Step Toward Democratic Capitalism,* 55 B.U. L. REV. 195, 206-07 (1975). These tax advantages presuppose a need to borrow money to purchase stock for a purpose such as facilitating the retirement of an existing owner or effecting an employee buyout. *See* Michael A. Conte & Jan Svejnar, *The Performance Effects of Employee Ownership Plans, in* PAYING FOR PRODUCTIVITY 143, 147 (Alan S. Blinder ed., 1990). The same net tax advantage may be secured by contributing stock to the ESOP in an amount equal to repayments on a loan unrelated to the purchase of stock. *Id.*

33. I.R.C. § 404(a)(9)(A), (B). For a detailed discussion of conditions and limitations on the employer deduction, see CANAN, *supra* note 28, § 3.37(A)-(B).

34. *See* GATES, *supra* note2; Jared Kaplan, *Is ESOP a Fable? Fabulous Uses and Benefits or Phenomenol Pitfalls?*, 65 TAXES 788 (1987).

35. *See* CANAN, *supra* note 28, § 3.32, 3.37G, 3.38; GATES, *supra* note 2, at 94-95.

36. I.R.C. § 404(a).

37. I.R.C. § 501(a).

38. I.R.C. § 402(e)(4).

39. I.R.C. § 404(k).

40. I.R.C. § 1042.

Fueled by tax advantages, the ESOP played a prominent role in the surge of employee stock ownership in the 1980s. In a survey of publicly held companies in 1989 and 1990, Blasi and Kruse found 8.6 million workers, representing 10% of the private-sector workforce, owned stock in public corporations in which employee ownership exceeds 4% of total company market value.[41] But public corporations tended to lose interest in ESOPs in the 1990s,[42] shifting instead to stock options as a favored form of employee ownership, and began to terminate more plans each year than were created.[43] Among smaller private corporations, however, the ESOP maintained considerable popularity as an estate-planning device.[44] In 1998, Corey Rosen, executive director of the National Center for Employee Ownership, reported that the leveraged ESOP was a "mature phenomenon."[45] While stressing the shortcomings of the relevant data bases, Rosen estimated that total ESOP assets, plus the assets of certain related benefit plans, were remaining constant at about $400 billion as terminations among publicly traded companies were offset by adoptions by smaller private firms.[46]

41. JOSEPH RAPHAEL BLASI & DOUGLAS LYNN KRUSE, THE NEW OWNERS, THE MASS EMERGENCE OF EMPLOYEE OWNERSHIP IN PUBLIC COMPANIES AND WHAT IT MEANS TO AMERICAN BUSINESS 13 (1991).

42. The reasons included a declining interest in ESOPs as a takeover defense as the phenomenon of hostile takeovers receded; a change in accounting rules for valuing allocations to individual accounts that reduced the corporations reported earnings; and the increased competition from broadly based stock options. *See* Michael E. Murphy, *Finding the Cheese: Through the Maze of Employee Stock Ownership*, 56 GUILD PRAC. 169, 171-74 (1999).

43. Corey Rosen, *Update for July 19, 1998*, The National Center for Employee Ownership, *at* http://www.nceo.org/columns/cr57.html (last visited July 14, 2004).

44. *See infra* note **Error! Bookmark not defined.** and accompanying text.

45. *See supra* note 43.

46. *See supra* note 43. Data from the filings of D.O.L. Form 5500 indicate that approximately 3.5 million employees participate in ESOPs. Douglas Kruse, *Research Evidence on Prevalence and Effects of Employee Ownership*, 14 J. EMP. OWNERSHIP L. & FIN., NO. 4, 65, 67 (2002).