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ARTICLE
ESOPs AND ECONOMIC DISTORTION

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Since 1974, Congress has created numerous tax benefits favoring Employee Stock Ownership Plans (ESOPs). Congress significantly expanded those benefits with the Deficit Reduction Act of 1984, and as a result the use of ESOPs is likely to increase substantially in the future.

In this Article, Professors Doernberg and Macey argue that ESOPs do not deliver the non-tax benefits claimed for them by proponents and cause inefficient market distortions. After exploring the history and requirements of ESOPs, they discuss various market distortions caused by ESOPs, with particular emphasis on the market for corporate control. After reviewing the treatment ESOPs have received in recent tax reform proposals, Professors Doernberg and Macey conclude by suggesting that many of the beneficial goals ESOPs are alleged to serve could be better achieved by modifying the laws governing individual retirement accounts.

We embark upon a critical journey through an area of tax-created incentives that have been widely praised, but narrowly understood. An Employee Stock Ownership Plan ("ESOP") is a deferred compensation plan where the employer's stock is held in trust for the benefit of employees. An employer can deduct the value of stock contributions to the trust while employees are permitted to postpone the recognition of income until they withdraw stock or other property from the trust.¹

Senator Russell Long (D-La.), a leading advocate of ESOP legislation in Congress, sings the praises of ESOPs as follows:

Tomorrow's economic system will be born out of the decisions that we in this Chamber make today . . . . We simply must enact incentives to insure that tomorrow's free enter-

¹ See infra text accompanying notes 50–59 for a discussion of the tax benefits associated with ESOPs. For a comprehensive treatment of ESOPs, see Elinsky, The Uses of ESOP's, 1984 N.Y.U. TAX INST. ON ERISA, 7-1 to 7-41; Kaplan & Ludwig, ESOPs, TAX MGMT. (BNA) No. 3542d; Ronan, Tax Incentives Encouraging Use of Employee Stock Ownership Plans As Corporate Finance and Anti-Takeover Devices, 58 TEMP. L.Q. 115 (1985).
prise system is financed so as to be more broadly owned

... By enacting such incentives, we can bring about a new sense of connection and participation. That, in turn, will help us to more fully enlist the drive, enthusiasm, and intelligence of the American public.²

There has been some criticism of the use of ESOPs. These critics have primarily argued that there are other tax-motivated transactions that offer corporations and plan participants the same strategic benefits as ESOPs at lower cost.³ This Article suggests that the problems with ESOPs are more fundamental. The tax advantages of ESOPs do not provide the non-tax benefits to workers that proponents suggest, and they cause inefficiency and distortion in the market.

It is not the tax advantages of ESOPs that cause problems. Rather, the severe limitations and restrictions on corporate behavior imposed by ESOP legislation are the cause of the undesirable inefficiency and distortion. Actually, the favorable tax treatment of ESOPs is largely consistent with the principles underlying a consumption tax.⁴ As discussed below, a con-

³ See, e.g., Baldwin, The Myths of Employee Ownership, FORBES, Apr. 23, 1984, at 108–10 (citing problems at worker-owned companies and suggesting successes may be due to factors other than ESOPs); Hoerr, ESOPs: Revolution or Ripoff?, Bus. Wk., Apr. 15, 1985, at 94, 102–10 (potential for abuse as shown by recent ESOP leveraged buyouts raise serious questions of ESOP utility to workers and to society at large); Huene, Beware the ESOP: A Cautionary Tale, 1976 TAX ADVISOR 722 (leveraged ESOPs are more expensive to present shareholders than conventional financing and rarely provide unique benefits); 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 (1975) (claimed benefits of ESOPs as a financing tool may be largely illusory; corporation better served by existing methods); Levin, Are Leveraged Employee Buyouts Fatally Flawed?, Wall St. J., Apr. 4, 1985, at 30, col. 3 (use of ESOP for leveraged employee buyout damaging to firm because it results in over-indebtedness without any real gain); Ronan, supra note 1, at 117–18 (insufficient safeguards for plan participants); Sherman & Lewis, The ESOP Fallacy, 3 J. Pension PLAN & COMPLIANCE 226 (1977) (touted benefits of ESOPs offset by drawbacks and available through conventional types of plans such as stock bonus and profit-sharing).
⁴ As its name implies, a consumption tax subjects a taxpayer to a tax on income used for consumption purposes rather than on all income. In many consumption tax configurations, consumption is measured by totalling a taxpayer’s income and then subtracting amounts saved or invested. The difference between income and savings (investments) is consumption. There is a rich literature on consumption taxes. See, e.g., Doernberg, A Workable Flat Rate Consumption Tax, 70 IOWA L. REV. 425 (1985) (discussing the proposal advanced by Robert E. Hall and Alvin Rabushka, senior fellows at the Hoover Institute); R. HALL & A. RABUSHKA, LOW TAX, SIMPLE TAX, FLAT TAX (1983); DEP’T OF TREASURY, BLUEPRINTS FOR BASIC TAX REFORM (1977); Bradford, The Case for a Personal Consumption Tax, in WHAT SHOULD BE TAXED INCOME OR EXPENDITURE 75 (J. Pechman ed. 1980); Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 HARV. L. REV. 1115 (1974).
sumption tax reverses the anti-saving, anti-investment bias of our income tax. Thus, in one sense, ESOPs may represent a step in the right direction. While the movement to a consumption tax offers much promise, the ESOP experience illustrates that piecemeal changes toward such a tax only guarantee complexity and inefficiency.

The use of ESOPs is not widespread, but the sharply enhanced tax benefits for ESOPs enacted as part of the Deficit Reduction Act of 1984 assure their rapid growth. While details of the 1984 changes are discussed below, perhaps the most significant change is tax-subsidized borrowing made available to corporations with ESOPs, which will enable them to borrow at lower interest rates than other borrowers. The availability of this preference will inevitably cause ESOP formation by firms that otherwise would not have considered the plans.

After a brief exploration of the history and requirements of ESOPs in Part I, this Article attempts to shed some light on the claims made by ESOP supporters in Part II. ESOPs are claimed to hold the key to curing much of what ails this country socially and economically. These claims simply are not supportable. Moreover, regulation of employee compensation through tax incentives alters behavior in an inefficient manner. Part III focuses on an important illustration of such inefficiency—the market for corporate control. Part IV addresses the effects that comprehensive tax reform might have on ESOPs.

I. How ESOPs Work

While the notion of employee stock ownership traces back to the nineteenth century, the modern era of ESOPs started in the 1950's when Louis Kelso first presented his thesis of own-

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5 See infra text accompanying note 85-90.
6 Accurate data on ESOPs is virtually impossible to obtain. One source has estimated 7000 ESOPs with nearly 10 million participants. Hoerr, Bus. Wk., supra note 3, at 94.
8 See infra text accompanying notes 55-59.
9 See I.R.C. § 133(a) (West Supp. 1985); Sheppard, ESOPs, Wealth Distribution, and Leveraged Buyouts, 1984 TAX NOTES 1270, 1271 (suggesting that ESOPs will be able to borrow at rates one-third lower than the prime lending rate).
10 See infra text accompanying note 83.
ership based on labor and capital. Kelso reasoned that technology is the principal factor in increasing productivity, and that technology operates solely on capital. Accordingly, Kelso viewed capital, not labor, as the primary source of wealth in an industrial society. He saw no way of sharing the affluence of the United States unless capital ownership was made available to labor. Neither he nor other ESOP advocates cogently explain why government regulation through tax incentives will lead to his goal of wealth redistribution throughout society.

According to Kelso, capitalist economies must artificially enlarge labor's share of income in order to avoid mass starvation and the concomitant social disorder. This wealth transfer supposedly is accomplished through unionization and the pursuit of inflationary full-employment policies that keep the demand for and the price of labor high. The excess income allocated to labor allegedly leads to a reduction in capital which leads in turn to inadequate development of new technology, stagnant productivity, and high rates of inflation. This wealth transfer also leads to a distortion in the allocation of income between labor and capital.

Kelso's solution to the perceived problem was to restructure the economic system so that capital resources would be more widely dispersed. This would allow capital to receive the rate of return Kelso believed it deserved without relegating laborers to poverty.

ESOPs were the mechanism for implementing Kelso's plan. He envisioned employee investment plans borrowing money (using the credit of the sponsoring employer) to finance corporate investment through the purchase of employer stock. The employer would then repay the original loan to the ESOP. As the loan was repaid, employees would become owners of large

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13 Id. at 39.
14 Id. at 171-72.
15 Kelso more recently contended that workers do not invest in capital because very few of them earn enough in wages to allow them the luxury of purchasing stock. Employee Stock Ownership Plans (ESOPs): Hearings Before the Joint Economic Committee, 94th Cong., 1st Sess. 134 (1975) (statement of Louis O. Kelso, Managing Director, Kelso Bangert & Co.) (hereinafter cited as Hearings).
16 Kelso estimated that labor's actual contribution to production is in the range of 10%, with capital contributing 90%. L. Kelso & M. Adler, supra note 12, at 41. Economists dispute his figures, arriving at a 75% contribution by labor to capital's 25%. T. Jochim, Employee Stock Ownership and Related Plans 12 (1982) (quoting Paul Samuelson, Nobel laureate in economics).
17 See L. Kelso & M. Adler, supra note 12, at 28-29.
blocks of capital in the form of stock allocated to their individual accounts.

The first such "leveraged" employee stock ownership plan was adopted in 1957. For reasons discussed extensively throughout this Article, the plans proved to be unpopular and few firms adopted them. All else equal, employees prefer compensation in the form of cash rather than stock in their employer's firm. Thus, from 1956 until 1974 Kelso's concept languished in obscurity.

Beginning in 1974, however, with the passage of the Employee Retirement Income Security Act of 1974 ("ERISA"), which established ESOPs as separately defined forms of stock bonus plans, replete with special fiduciary and distribution requirements, ESOPs have steadily gained in popularity. Congress has given employers massive regulatory incentives to create ESOPs, thus correcting the market's failure to do so on its own. Before 1984, these incentives met with limited success;

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18 The first leveraged ESOP was started by Peninsula Newspapers, Inc. STAFF OF JOINT ECON. COMM., 94TH CONG., 2D SESS., BROADENING THE OWNERSHIP OF NEW CAPITAL: ESOPS AND OTHER ALTERNATIVES 58 (Comm. Print 1976) [hereinafter cited as JOINT ECON. COMM. STAFF].
19 Estimates vary, but most authorities put the number of ESOPs in 1975 in the 200–300 range. See Hearings, supra note 15, at 93 (app. to statement of Charles Walker, Ass't Sec'y Tax Pol'y, U.S. Treas. Dep't). Of the 229 firms responding to a nonscientific survey conducted by the ESOP Association in 1983, only 37 (16%) had established their ESOPs before 1975. The ESOP Association, ESOP Survey 1983, at 15. The relative paucity of ESOPs prompted a congressional staff studying them to state that they had not been "widely adopted." JOINT ECON. COMM. STAFF, supra note 18, at 59.
20 See infra note 21. ESOPs, unlike other qualified plans, can transact with the employer or an interest or otherwise disqualified person, I.R.C. § 4975(d)(3) (1982), and benefits arising under an ESOP must, in most instances, be distributable in employer securities. Id. § 4975(e)(7) (requiring compliance with I.R.C. § 409(h) (West Supp. 1985)).

although there were over 5000 ESOPs in existence by 1983 they still were not much of a factor in the compensation of workers. But the Deficit Reduction Act of 1984 ushered in a new era for ESOPs.

A. The Structure of an ESOP

An ESOP gives employers who pay some portion of an employee's compensation in the form of stock significant tax advantages. The stock is held by a trust, unavailable to employ-


To make ESOPs and TRASOPs more attractive to closely-held corporations, the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, 2787-96, allowed for distributions in cash rather than stock and implemented a put-option requirement for stock not readily marketable. Id. at 2789.

Congress destroyed TRASOPs with the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172, 289-96, by eliminating the tie-in of the contribution allowance to the investment tax credit, but continued the tax credit idea by allowing a credit, equal to up to one-half percent of payroll, for contributions to a "PAYSOP."

The Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, made ESOPs substantially more attractive, with its provisions for a rollover of gains from sale of stock to an ESOP, I.R.C. § 1042 (West Supp. 1985); for deduction of cash dividend payments, id. § 404(k); for exclusion by the lender of 50% of the interest earned on ESOP loans, id. § 133(a); and for assumption by an ESOP of estate tax liability in an amount equal to the value of stock held by the estate transferred to the ESOP. Id. § 2210.


23 I.R.C. § 4975(e)(7) (1982) defines an ESOP as "a qualified stock bonus plan, or a stock bonus and money purchase plan both of which are designed to invest primarily in qualifying employer securities . . . ." I.R.C. § 414(i) (1982).

In a "defined contribution plan" where allowable contributions to the plan are either fixed or limited, the benefits received by employees depend on the contribution levels.

Treasury regulations describe a stock bonus plan essentially as a profit-sharing plan in which employer contributions are not necessarily tied to profits and distributions to plan participants are in the form of employer securities. Treas. Reg. § 1.401-1(b)(1)(iii) (1960). The stock bonus plan may provide a strict formula for yearly employer contributions or may leave the amount of yearly contributions to the employer's discretion. Id. § 1.401-1(a)(2)(iii).

A money purchase plan sets a definite formula or a specific amount for the yearly employer contribution. See Id. § 1.401-1(b)(1)(i); Rev. Rul. 57-312, 1957-2 C.B. 255.

The regimen for qualification under I.R.C. § 401 is multifaceted. For an in-depth consideration of the provisions see Ronan, supra note 1, at 119-33.
eees until retirement. The employer receives a tax deduction of the stock's fair market value at the time it is contributed to the trust, and employees are not taxed on the stock until they withdraw it. The plan must invest primarily in qualifying employer securities—generally common stock. Although an ESOP must be "designed to invest primarily" in employer securities, the phrase is not defined, nor are there any judicial or administrative rulings on the meaning of "primarily" or the percentage of trust assets that must be qualifying employer securities. Instead of contributing stock itself, employers can make cash contributions to ESOPs that can be used by the ESOP to purchase stock from shareholders or from the employer.

Contributions to ESOPs must not discriminate in favor of officers, shareholders, or other highly compensated employ-

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25 Id. § 402(a). Many of the technicalities governing the treatment of ESOPs will be simplified or ignored for the purposes of this discussion where, in the author's opinion, they add nothing to the arguments.
26 A qualifying employer security is common stock of the employer that either is readily tradable on an established market or has a combination of voting power and dividend rights equal to or in excess of the most favorable dividend rights and voting power of any other class of common stock. I.R.C. § 409(1) (West Supp. 1985). Non-cancellable preferred stock can be a qualifying employer security if it is convertible into qualified common stock at a reasonable price at any time. Id. Bonds, debentures, or other debt instruments do not constitute qualifying employer securities even if marketable. Id. Stock issued by corporations controlled by the employer can also satisfy the qualifying employer securities requirement. I.R.C. §§ 4975(e)(8) (1982), 409(1) (West Supp. 1985). See Ronan, supra note 1, at 125–26.
27 A plan may invest in assets other than qualifying employer securities as long as it satisfies the "primarily" test. Treas. Reg. § 54.4975-1l(b) (1977).
28 One writer has suggested a 51% qualifying threshold. Elinsky, supra note 1, at § 7.03[2]. A survey conducted in 1983 by the ESOP Association found that approximately 80% of the respondent plans had at least 75% of their assets invested in employer stock, with the overall average investment level for the 225 plans responding being 87.7%. THE ESOP ASSOCIATION, supra note 19, at 28–29.
29 A leveraged ESOP can be a highly desirable mechanism for buying out a principal shareholder, for both the company and the selling stockholder. If three conditions are met, the shareholder can avoid having to meet the requirements of I.R.C. § 302 (1982) in order to secure capital gains treatment on the sale. The three conditions, imposed by implication of Rev. Proc. 77-30, 1977-2 C.B. 539, are: (1) the selling shareholder and related persons cannot "own" more than 20% of the beneficial interest in the ESOP; (2) restrictions on distribution of the stock sold to the ESOP by the shareholder cannot be harsher than restrictions on a majority of stock held by other shareholders; and (3) the employer and the ESOP must expressly state that redemption of the stock from the ESOP is not contemplated. Moreover, the shareholder can defer taxation on the gain realized from the sale by reinvesting the proceeds in certain qualifying securities within a specified period of time. I.R.C. § 1042 (West Supp. 1985). For further analysis of the requirements for a leveraged ESOP buyout of a principal stockholder, see Ronan, supra note 1, at 145–49.
In addition, the ESOP must satisfy a medley of minimum participation and vesting standards, imposed to shore up the nondiscriminatory aims of preferential pension legislation. An ESOP must cover either seventy percent or more of all employees, or eighty percent of all eligible employees as long as seventy percent or more of the employees are eligible, or satisfy the Secretary of Labor that the classification used is not discriminatory. The benefits that accrue to a participant’s account from the corporation’s contributions must vest according to a choice of vesting schedules ranging from no vesting during the first ten years of service, to 100% vesting upon completion of year ten, to gradual vesting from the end of five years of service.

30 I.R.C. § 401(a)(d) (1982). Benefits and contributions may be proportional to compensation without being deemed discriminatory. Id. § 401(a)(5).

If a plan is found to be “top-heavy,” i.e., if “key employees” (officers, those earning more than the current $30,000 limit in § 415(c)(1)(A), and “owners”), I.R.C. § 116(c)(1)(A) (West Supp. 1985), have account balances which, combined, exceed 60% of the sum of the account balances of all employees under the plan, I.R.C. § 416(g)(1) (1982), the plan is subject to the more stringent contribution and vesting rules of I.R.C. §§ 416(b), (c), and (h) (1982). An employee is an “owner” for purposes of the “key employee” definition if he is one of the 10 largest shareholders of the employer, owns more than one-half of one percent of the outstanding employer securities and earns more than the limit set by I.R.C. § 415(c)(1)(A) (1982); or if he owns five percent of the outstanding securities issued by the employer; or earns over $150,000 per year from the employer and owns at least a one percent interest in the employer. Treas. Reg. § 1.416-1 (1984).

31 See generally I.R.C. §§ 401 (1982) (discrimination in favor of “prohibited group” of officers, shareholders or highly paid employees disallowed), 410 (establishing minimum participation standards), 411 (setting forth three minimum vesting schemes and blanket prohibition of “pattern of abuse”) and 416 (setting forth procedure for determining if plan is top-heavy and penalty for top-heavy plans). See Kaplan & Ludwig, supra note 1, at A-7 to A-9, for an excellent and concise explanation of the participation and vesting requirements.


Universal participation is not mandated. The plan may include a minimum age for participation not exceeding 21 years, I.R.C. § 410(a)(1)(A)(i) (1982), a minimum length of employment, id. § 410(a)(1)(A)(ii), and minimum continuous service requirements, id. § 410(a)(1)(B) (West Supp. 1985), but may not place a limit on a participant’s maximum age, id. § 410(a)(2) (1982). Employees may be temporarily excluded from participation in employer contributions and reallocation of forfeitures for years in which they complete less than 1000 hours of service, id. § 411(b)(3)(C), or for periods in which they fail to make mandatory contributions to the plan, id. § 411(a)(4)(B). Employees temporarily excluded must nonetheless continue to share in profits and losses of the plan. Id. § 411(b)(3).
through fifteen years of service.\textsuperscript{33} Whatever vesting schedule is chosen, I.R.C. § 411(d)(1)\textsuperscript{34} prohibits any pattern of abuse, such as dismissal, which may tend to discriminate in favor of employees who are officers, shareholders, or highly compensated.

All ESOP assets must be held in trust and be managed by a trustee.\textsuperscript{35} With some exceptions,\textsuperscript{36} the trustee is named by the sponsor corporation’s board of directors or a committee appointed by the board and is subject to the direction and authority of the appointing group.\textsuperscript{37} The trustee is subject to the general fiduciary rules of ERISA requiring him or her to act with prudence exclusively for the purpose of providing benefits to participants.\textsuperscript{38} However, other basic fiduciary requirements applicable to pension plans are relaxed to account for the special purpose of ESOPs. ESOPs are exempt from the diversification requirements normally imposed on pension plan trustees since ESOPs are designed to invest in employer’s stock.\textsuperscript{39} ESOPs can also purchase stock from an employer or from other parties in interest (major shareholders, officers, and directors) even though I.R.C. § 4975 prohibits such transactions for most pension plans.\textsuperscript{40} In addition, I.R.C. § 4975(d)(3) and ERISA § 408(b)(3) permit an ESOP to borrow money from a party in interest, such as the employer, for the acquisition of employer stock.\textsuperscript{41}

\begin{itemize}
  \item \textsuperscript{33} \textit{Id.} § 411(a). The vesting schedules concern only those allocations or contributions to an employee’s account that are attributable to the employer. An employee must always be 100\% vested in his own contributions. \textit{Id.} § 411(a)(1).
  \item \textsuperscript{34} \textit{Id.} § 411(d)(1).
  \item \textit{ERISA, supra} note 21, at §§ 402(a)(1) and 403(a), 29 U.S.C. §§ 1102(a)(1) and 1103(a).
  \item \textsuperscript{35} See \textit{id.} § 403(a)(2), 29 U.S.C. § 1103(a)(2).
  \item \textit{Id.} at § 403(a)(1), 29 U.S.C. § 1103(a)(1).
  \item \textit{Id.} at § 404(a)(1), 29 U.S.C. § 1104(a)(1).
  \item \textit{Id.} at § 404(a)(2), 29 U.S.C. § 1104(a)(2). To the extent that an ESOP invests in assets other than the employer’s stock, ERISA’s diversification requirements apply. \textit{Id.} at § 404(a)(1), 29 U.S.C. § 1104(a)(1).
  \item \textit{Id.} at § 408(e), 29 U.S.C. § 1108(e). The exemption applies only if the price paid for the stock constitutes “adequate consideration.” \textit{Id.}
  \item \textit{Id.} at § 408(e), 29 U.S.C. § 1108(e); I.R.C. § 4975(d)(3) (1982). This exception to normal fiduciary restrictions covers direct loans, loan guarantees and installment sales, and assumes compliance with restrictions, including a reasonable interest rate, collateral restricted to employer securities, and primary benefit to employees. The Departments of Labor and Treasury have placed restrictions on ESOP “interested party” loans. 29 C.F.R. § 2550.408b-3(e) (1984); Treas. Reg. § 54.4975-7(b)(3) (1977). These posit an “arms-length transaction” standard to test the fairness of the loan terms and prohibit transactions which would siphon off the plan assets. In addition to limiting collateral to the employer securities being purchased with loan proceeds, 29 C.F.R. § 2550.408b-3(e) (1984) and Treas. Reg. § 54.4975-7(b)(5) (1977) mandate a “no recourse” clause in the loan provisions and restrict the plan’s liability for repayment to employer contributions.
\end{itemize}
ESOP participants must be entitled to vote the stock held in their accounts. If the issuing corporation has no outstanding stock that must be registered, no voting rights pass-through is required except where, according to the corporate charter or applicable law, a matter must be decided by more than a majority vote of the outstanding common shares voted.

If a participant in an ESOP is entitled to a distribution, he must have the right to demand that his benefits be distributed in the form of employer securities. If no demand is made, the employer can make cash distributions. Unless the securities received can be readily traded on an established market, a participant must have the right to require the employer (not the ESOP) to repurchase the securities for their fair market value.

The annual contribution and other additions for an ESOP participant cannot exceed the lesser of thirty thousand dollars or twenty-five percent of annual compensation. Similarly sit-

other than stock, earnings on such contributions, and cash dividends on employer stock. Under 29 C.F.R. § 2550.408b-3(e) (1984) and Treas. Reg. § 54.4975-7(b)(8) (1977), the encumbered shares of employer stock must be released to participants' accounts as the loan is repaid. Demand loans are not permitted and a definite term must be set. 29 C.F.R. § 2550.408b-3(f) (1984); Treas. Reg. § 54.4975-7(b)(7) (1977).

If an ESOP interested party loan fails to satisfy any of the conditions described above, the loan may be declared a prohibited transaction under I.R.C. § 4975 and the transgressing interested party may incur a five percent excise tax penalty, which can be increased to 100% if the transaction is not sanitized. I.R.C. §§ 4975(a) and (c) (1982).

I.R.C. §§ 409(e)(3) (West Supp. 1985) and 401(a)(22) (1982). The minimal voting rights requirement seems inadequate in view of the stated purpose of ESOPs; to give the employee some ownership interest in his employer. See generally ERISA, supra note 21, at § 402, 29 U.S.C. § 1102. As pointed out by Ronan, supra note 1, at 128-30, stock is allocated to the accounts of participants in a leveraged ESOP only as the loan taken out to purchase the stock is paid off. See Treas. Reg. §§ 54.4975-11(c),(d); 54.4975-7(b)(8)(15) (1977). Employees have no voting control at all until stock is allocated to their individual accounts. See I.R.C. §§ 4975(e) (1982), 409(e) (West Supp. 1985). Even after allocation, employees of companies with no securities required to be registered may vote only on a few relatively rare corporate transactions. This provision is particularly disturbing because many companies with ESOPs are small, closely-held corporations which are unlikely to have registered securities. See infra text accompanying notes 102-03. Thus, participants are often effectively excluded from the control normally incident to corporate ownership.


Id. § 409(b)(2).

Id. § 409(b)(1)(B).

Id. § 415(c)(1) (1982). For purposes of the annual addition limitation, an employee's "compensation" includes, in addition to his or her salary and other usual components, employer contributions to defined contribution plans, forfeitures allocated to the employee's account and the lesser of one-half of employee contributions or all employee contributions over six percent of compensation. See id. § 415(c)(2).

Starting in 1986, the $30,000 limitation will be adjusted for cost-of-living increases. If an ESOP allocates one third or less of employer contributions to officers, ten-percent shareholders, or highly compensated employees, the annual addition limitation can be
uated employees must be treated in a nondiscriminatory manner under the plan.\(^{48}\) In determining the amounts allocated to the accounts of participants, forfeitures from unvested accounts do not increase the allocable amounts, but instead reduce the employer's allowable tax-deductible contribution.\(^{49}\)

**B. The Tax Treatment of an ESOP**

Traditionally, there have been three primary tax benefits to ESOPs. First, employers can deduct contributions to an ESOP in an amount up to twenty-five percent of the compensation of all participants.\(^{50}\) No ceiling exists where the employer's contributions are used by the plan to pay interest on a loan incurred to buy employer securities.\(^{51}\) Second, income earned by the trust is exempt from taxation until distributed.\(^{52}\) Third, employees are taxed on distributions when made, but can use certain averaging and rollover provisions not ordinarily available to non-pension plan compensation.\(^{53}\) While all qualified pension plans enjoy tax incentives as compared with direct compensation, the liberal deduction limitations for employer contributions to an ESOP along with the borrowing opportunities available through an ESOP offer significant advantages which other types of pension plans cannot match.

Four new provisions enacted as part of the Deficit Reduction Act of 1984\(^ {54}\) give ESOPs even greater tax advantages over other forms of compensation. First, any shareholder who sells qualified doubled to the extent that the additional allocation is used for employer securities either contributed to or purchased by the plan. \(\text{Id. } \S 415(e)(6).\)

\(^{48}\) See supra notes 30–32.


\(^{50}\) I.R.C. \(\S 404\) (West Supp. 1985). For an ESOP consisting only of a stock bonus plan, the employer may deduct contributions up to 15% of total compensation of participants and carry over into future years any unused portion of the ceiling. \(\text{See id. } \S 404(a)(3)(A).\) Where an employer maintains a stock bonus plan in conjunction with some other type of pension plan, there is a ceiling on total deductible contributions equal to 25% of total compensation. \(\text{Id. } \S 404(a)(7).\)

\(^{51}\) Id. \(\S 404(a)(9)(B).\) Employer contributions to an ESOP to permit the ESOP's repayment of loan principal are deductible up to 25% of the compensation of participating employees without regard to employer contributions to other plans. \(\text{See id. } \S 404(a)(9)(A).\) Note that the limits on deductibility may in some cases be more stringent than the individual allocation limits. An employer is free to make nondeductible contributions in excess of the deduction limitation so long as the individual allocation limits are not exceeded. \(\text{Id.}\)

\(^{52}\) Id. \(\S\S 501(a), (c), (d)\) (1982).

\(^{53}\) Id. \(\S\S 402(a), (e).\) See infra note 55.

fied stock to an ESOP can elect to defer any taxable gain if: (1) the proceeds are reinvested within a year in securities of a domestic corporation; and (2) after the sale, the ESOP owns thirty percent of the value of all employer stock. This provision creates a strong tax incentive for shareholders to sell their stock to an ESOP rather than to other purchasers because sales to non-ESOP purchasers do not permit any deferral of gain, regardless of timely reinvestment.

Second, the employer corporation is permitted a deduction for cash dividends paid on stock held by an ESOP if the dividends are distributed to ESOP participants. Distributing corporations generally do not receive deductions for dividends paid.

Third, I.R.C. § 2210 allows an ESOP to assume a decedent's estate tax liability in exchange for employer securities of equal value. This provision allows large shareholders to cope with liquidity problems in connection with estate tax obligations.

55 I.R.C. § 1042 (West Supp. 1985). Rollover treatment is afforded only to shareholders of a corporation lacking any ready, established market for its securities. Id. § 1042(c)(1)(A). To qualify for this special nonrecognition provision, the taxpayer must have held the securities for at least one year, and they cannot have been acquired either through a qualified plan or stock option arrangement. Id. §§ 1042(c)(1)(B), 1042(c)(1)(C). Nonrecognition treatment is unavailable if the ESOP allocates the purchased securities for the benefit of the selling shareholder, family members, or any other person who owns more than 25% of the employer's stock. Id. § 1042(b)(3)(C).

The selling shareholder is entitled to exclude from income any gain from the sale which is reinvested in "qualified replacement property," defined as securities issued by any domestic corporation with passive investment income (e.g., dividends, rents, royalties) not exceeding 25% of gross receipts. Id. §§ 1042(a), 1042(c)(4). The qualified replacement property must be purchased at any time from three months prior to and 12 months after the sale. Any gain in excess of the cost of the qualified replacement property is recognized as income. See id. § 1042(c)(4). The "rollover" characteristic of these transactions is attributable to the reduction of the shareholder's basis in the replacement property by the amount of the gain not recognized by virtue of the ESOP-favored treatment. See I.R.C. § 1042(d) (West Supp. 1985).

The Code authorizes the imposition of an excise tax on the employer—hence, the requirement of employer consent to a shareholder's nonrecognition election—where the stock acquired by the ESOP is disposed of within three years, and such disposal decreases the total number of ESOP-owned shares or causes the ESOP to own less than 30% of the employer's securities. See generally id. § 4978.

56 Id. § 404(k). The dividend must be paid in cash and be distributed to plan participants within 90 days of the close of the plan year. Id. § 404(k)(2). As stated in Ronan, supra note 1, at 141–42, since participants' interest in stock bought with the proceeds of an ESOP loan is minimal until the loan principal begins to be paid off, the dividend deduction is of little value to a corporation in the early years of a leveraged ESOP because the participants lack sufficient beneficial ownership in the stock to entitle them to dividends.

57 I.R.C. § 2210 (West Supp. 1985) also provides generous deferral provisions for the ESOP's payment of the estate taxes. If the ESOP and the estate qualify, the ESOP may defer payment of the assumed tax liability for up to five years and nine months and may take up to 10 years following the first installment to pay off the entire liability. Id.
The fourth change will likely be the most significant in encouraging a dramatic increase in the use of ESOPs. An institutional lender who extends a loan to an ESOP for the purpose of enabling the plan to acquire employer securities can exclude from income fifty percent of the interest received on the loans. The partial exemption will result in lower interest rates to ESOP-borrowers and ultimately will lower the cost of financing projects to corporate sponsors who sell employer securities to the ESOP.

C. The Dynamics of ESOP Use

If no preferential tax treatment were given to ESOPs, other pension plans, or other forms of compensation, employees generally would elect to receive all compensation in the form of cash. This is because cash offers employees the greatest flexibility for making expenditure choices among competing alternatives. Corporations desiring capital for projects would have to compete for funds from investors and lenders. There would be no particular reason why employee-investors would be any more disposed to purchase their employer’s stock than outside investors. Perhaps some investors would invest or lend money to their employer; others would not.

The tax advantages accorded various forms of compensation changes their relative desirability and their use by employees. Compare compensation through an ESOP with direct cash payment. Suppose employee ("EE") and his employer ("ER") determine that EE’s services are worth $50,000 per year. Suppose further that the compensation alternatives are either $50,000 in cash or $40,000 in cash and a $10,000 contribution to an ESOP to be allocated to EE’s account. If EE receives all cash, ER receives a $50,000 deduction and EE is taxed on the compensation received. At this point, whatever expenditure choice

§ 6166(a) (1982). The installment payment method requires only four percent interest payments, and employer contributions to pay the interest are deductible. Id. §§ 2210(c)(2), 404(a)(9)(B) (West Supp. 1985).

§ Id. § 133(a).

See infra text accompanying notes 66–72.

As indicated below, it is likely that the tax benefits associated with an ESOP will be divided between the employer (i.e. shareholders) and employees depending on the elasticities of the demand and supply curves for labor. See infra text accompanying note 72.

EE makes (for example, to purchase ER's stock), the expenditure will be made with after-tax dollars.

If EE receives $40,000 in cash and a $10,000 contribution to EE's account in an ESOP, the treatment of the cash compensation does not change. From ER's perspective, the contribution to the ESOP, like a $10,000 cash payment, will generate a $10,000 deduction. Moreover, the existence of an ESOP will permit ER to raise capital at less expense. For EE the contribution to an ESOP means that $10,000 is unavailable for expenditure on alternative investments or consumption. Stated differently, EE is induced by the tax system to invest a portion of his compensation in ER's stock. In exchange for the limitation on EE's expenditure choice, EE is not taxed on the contribution to the ESOP nor on any income earned by the ESOP until it is distributed. The ability to invest pre-tax dollars in ER's stock and to escape immediate taxation on the earnings of the stock will influence EEs on the margin to prefer the ESOP contribution to a cash payment.

ESOPs represent only one of several deferred compensation arrangements, all of which share certain basic tax benefits, including immediate deduction for the employer and deferral of taxation for the employee on both the initial contribution and any income it generates. The total amount of compensation that an employer can contribute to all types of pension plans that an employer might maintain is limited by statute. In light of these limitations, it is worthwhile to consider why an ESOP may offer advantages over other pension plans.

The general fiduciary rules that govern the management of pension trusts prohibit most sale and loan transactions between a pension plan and a party in interest, including the employer, major shareholders, directors, and officers. This restriction

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62 Id. § 404(a) (West Supp. 1985).
63 Because the employer is only "bargaining" with the ESOP in a "leveraged" ESOP transaction (see infra text accompanying notes 63–66), rather than with many buyers in the open market, the transaction costs of raising capital through an ESOP are lower. An ESOP transaction may also avoid the cost of underwriting and registering a new stock issue. See Elinsky, supra note 1, at § 7.04[2][c].
64 I.R.C. § 404 (West Supp. 1985). This section along with §§ 402(a) and 403(a) are part of the sweeping reforms brought about by the enactment of ERISA, supra note 21.
66 Id. § 4975 (1982). The "prohibited transaction" rules do not completely deny plans the right to do business with interested persons. Defined benefit plans generally may
makes most pension plans unsuitable as a means of raising capital. ESOPs, on the other hand, offer ready financing for employers because these restrictions do not apply. In the example above, ER can retain $10,000 in cash that would otherwise be paid to EE by contributing stock worth $10,000 to an ESOP. An ESOP also can borrow at subsidized rates to purchase stock of the employer, providing another method of financing projects. If an ESOP borrows money from a bank and uses the proceeds to purchase stock from the employer, it is as though the employer has borrowed money directly from the bank. The loan is repaid through annual employer contributions to the ESOP which in turn repays the lender. Use of an ESOP to fund corporate projects in this manner is referred to as leveraging.

To illustrate how a leveraged ESOP might work, suppose that X Corporation ("X Corp.") wishes to borrow one million dollars for a building project that is expected to produce $554,820 a year for five years. The project will require a present value of one million dollars in labor costs payable over the five-year period in annual installments of $277,410. Assume that the loan is repayable over the same five-year period with annual payments equal to $277,410. At the market discount rate of twelve percent built into the loan repayment schedule, X Corp. will be indifferent about undertaking the project.

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invest up to 10% of assets in the employer corporation without need of providing any voting rights pass-through to participants or of making distributions in employer stock. ERISA, supra note 21, at § 407(a), 29 U.S.C. § 1107(a), I.R.C. §§ 401(a)(22), (23) (1982). Profit-sharing and stock-bonus plans may invest over 10% of plan assets in the employer by including a clause allowing greater investment in the trust agreement itself. ERISA, supra note 21, at § 407(d)(3), 29 U.S.C. § 1107(d)(3).

67 See supra text accompanying notes 9, 58–59.
68 See supra note 3.
69 If the project produces one penny more, X Corp. would undertake the project.

Besides the 12% market discount rate, this example assumes: (1) a 50% flat tax rate for all taxpayers; (2) a sinking fund depreciation schedule, see M. Chirelstein, Federal Income Taxation 133–35 (1985); and (3) the absence of inflation.

With sinking fund depreciation, the one million dollar cost of the building would be recovered as follows:

Year 1: $157,410
Year 2: $176,299
Year 3: $197,455
Year 4: $221,149
Year 5: $247,687

The loan principal would be amortized on the same schedule, thereby producing the
Prior to the Deficit Reduction Act of 1984, if X Corp. investigated financing the project through an ESOP, it would decide to proceed. Typically, the ESOP would borrow $1,000,000 from a bank. As part of the loan, the employer would guarantee the loan and promise to contribute enough money to the ESOP to permit the plan to make annual repayments. The ESOP would use the proceeds to purchase one million dollars worth of stock from X Corp. Every year X Corp. would contribute $277,410 to the ESOP, enough to pay loan principal and interest. Compared with direct financing, use of the ESOP leaves X Corp. with $277,410 in cash (minus taxes) each year during the five-year period because stock was used for compensation purposes rather than cash.\(^7\)

The Deficit Reduction Act of 1984 made financing through an ESOP even more advantageous. Because the bank can exclude interest payments received from the ESOP, the interest rate charged will inevitably be lower.\(^71\) For example, if the bank charges nine percent interest instead of twelve percent, X

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\text{following interest deductions computed by subtracting the loan principal amortization from the annual $277,410 loan repayment:}
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- Year 1: $120,000
- Year 2: $101,111
- Year 3: $ 79,955
- Year 4: $ 56,261
- Year 5: $ 29,723

With this in mind, consider Year 1. X Corp. receives $554,820 but must pay $277,410 in labor costs and $277,410 to the bank. If there is any tax liability, X Corp. would not undertake the project. However, the $554,820 in income is offset by the $277,410 deduction for compensation under I.R.C. \$ 162(a)(1) (1982), the $120,000 interest deduction under I.R.C. \$ 163 and the $157,410 depreciation deduction under I.R.C. \$ 168. Similarly, there will be no tax liability in Years 2–5 since the interest and depreciation deductions will always total $277,410.

If X Corp. distributed its own stock rather than cash to its employees: (1) the tax treatment of both the employer and employees would remain the same except that the employees would have a tax liability on the fair market value of the $277,410 received annually without having the cash to pay the taxes; and (2) X Corp. would retain $277,410 each year since compensation was paid in stock.

\(^7\) Using the tables set forth in \textit{supra} note 69, in Year 1, X Corp. would have income of $554,820 offset by a depreciation deduction of $157,410 and a deduction for the contribution to the ESOP in the amount of $277,410. \textit{See} I.R.C. \$ 404(a)(9) (West Supp. 1985). If it is in a 30% tax bracket X Corp. would pay $60,000 of taxes on the $120,000 of taxable income. The employees would not be taxed on the employer's contributions to the employee stock ownership trust. \textit{See} I.R.C. \$ 402(a)(1) (1982). Thus, comparing this configuration with the nonqualified use of stock, \textit{supra} note 69, in both cases X Corp. has the use of $277,410 annually. Using nonqualified stock outside of the ESOP context leads to a large tax on employees. Use of stock through an ESOP leads to a smaller tax on the employer. Since the overall tax bite is smaller in the ESOP context, X Corp. and its employees can be expected to divide the tax savings in a pareto optimal manner. \textit{See infra} note 72.

\(^71\) \textit{See} Sheppard, \textit{supra} note 9, \textit{see also} text accompanying note 52.
Corp.'s annual payments will be $257,093, a $20,317 savings each year over the five-year period. The present value of the savings at the commencement of the project is $73,239 before taxes, or $36,620, assuming a fifty percent tax rate.

How these tax savings will be shared between employer and employee is an empirical question depending on the elasticities of the labor supply and demand curves facing a firm. If the firm faces a firm-specific inelastic supply curve for labor, perhaps because of specialized training or high relocation costs, the firm rather than its employees will capture the lion's share of ESOP tax benefits. If it is costly for employees to collect information about and to move to other job opportunities even within the same industry, a firm will not have to use its tax benefits to retain employees and will be unable to use its tax benefits to attract new employees.72

72 To take the extreme example, suppose that a firm faces a totally inelastic supply curve for labor. The wage rate will be set at the minimum point on the inelastic curve. Payment of a penny less will drive all workers to other pursuits. Payment of a penny more is wasteful for the firm since no new workers will be attracted. If ESOP tax benefits are introduced, X Corp. can attract the same number of workers by paying less—the government makes up the difference. Consequently, X Corp. rather than the employees would benefit from the ESOP tax benefits.

If a firm does not face a firm-specific inelastic labor supply curve, then the division of the tax benefits will depend on the elasticity of the industry-wide labor supply curve. If the supply of labor is very elastic so that a small rise in wage levels will result in a substantial increase in the supply of workers, we can represent the market for labor as follows:

If tax benefits are introduced, X corp. can now get more labor for the same amount
The use of a leveraged ESOP to fund projects less expensively than through conventional financing leads to a variety of distortions. The savings to a corporation or its employees from borrowing through an ESOP are not wealth-created savings. Rather the savings simply represent a tax transfer from all taxpayers to the corporation and those enrolled in ESOPs.

In addition to serving as a financing tool, an ESOP can provide a market for the employer's securities in the close corporation setting, thereby enabling shareholders to lessen the tax burden of cashing in on the corporation's earnings. Suppose X Corp. is managed by five key employees who own seventy-five percent of its outstanding stock. If X Corp. performs well, and the shareholders want to distribute the earnings to themselves, the key employee-shareholders will be unable to obtain the earnings without being taxed at ordinary income rates. If a distribution is made or if there is a pro rata redemption, ordinary income of money. Under such circumstances, X Corp. can attract new employees and still capture a large share of the tax benefits.

If the labor supply for the industry is very inelastic, however, such that changes in wage level do not materially affect the supply of workers, X Corp. will have to give most of the tax benefits to labor. This is because wages must be raised substantially before new workers are attracted. If a firm does not increase wages, competitors will bid away the firm's employees.

If a firm faces a firm-specific inelastic labor supply curve, however, as noted in the text, then regardless of the elasticity of the labor supply for the industry, the firm will capture most of the ESOP tax benefits.

73 See infra text accompanying notes 92-94.
treatment will ensue. If the employee-shareholders sell their stock to an independent third party, capital gains treatment may apply. There may be no market for stock of a closely held corporation, however, and even if there is, the key managers may be wary of giving up control. If they try to sell to a controlled third party, like a newly formed controlled corporation, again ordinary income treatment results.

But, if X Corp. sets up an ESOP, the plan can purchase stock, giving the sellers the benefit of capital gains treatment without having to sell to a fully independent third party and providing X Corp. with a deduction for earnings contributed to the ESOP. Typically, the ESOP would borrow funds from a bank at a tax subsidized interest rate. The funds would be used to purchase the stock from the key managers. On an annual basis X Corp. would make tax deductible contributions to the ESOP which would be used to repay the loan with interest. While the sale of stock to an ESOP would reduce the ownership interest of the key managers, the reduction would be mitigated to the extent that the managers were also ESOP participants. The Internal Revenue Service will issue an advance ruling that a proposed sale to an ESOP will qualify for capital gains treatment if: (1) the beneficial interest of the selling shareholders in the ESOP does not exceed twenty percent; (2) the stock is no more restricted than other employer stock; and (3) the employer does not intend to redeem stock from the plan.

Participants not only may receive capital gains treatment on a sale to an ESOP, but also may reinvest the proceeds in a timely and appropriate fashion, so as to postpone recognition of any gain on the sale. Therefore a seller may postpone recognition of gain on a sale to the ESOP while recognizing any loss on a similar sale where the proceeds are not reinvested.

II. THE SUPPOSED BENEFITS OF ESOPs

Ironically, the most vocal proponents of ESOPs have based their support for the regulatory incentives encouraging ESOPs

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75 See id. § 301.
76 See id. § 302(c)(2)(C).
77 See id. § 304.
78 The ESOP will be considered the alter ego of the employer for purposes of evaluating the tax consequences of a redemption unless three conditions are met. See supra note 29.
80 The "rollover" provision is outlined at supra note 55.
on a commitment to a private property, free enterprise philosophy. The notion seems to be that employee stock ownership is a good idea because it will transform workers into budding capitalists, thereby improving productivity and broadening the capital base.

The proponents of ESOP legislation extol its virtues in a manner similar to those who peddle Ponzi schemes. Everyone wins and no one loses. Employees supposedly benefit because they are able to share in the financial success of the firm. Other shareholders are supposed to benefit because the firm as a whole is more valuable due to increased worker productivity. Society is allegedly better off because current inequalities in the distribution of wealth are ameliorated and the level of savings and investment increases.

If ESOPs are such an efficient method of employee compensation, one wonders why firms need such strong tax incentives to establish them. If ESOPs are truly "wealth creating" and efficient in the sense that they make workers better off without making anyone else worse off, there would be no need for regulatory coaxing to induce firms to implement them. If these plans provided benefits resembling those envisioned by their proponents, marginal firms that did not develop ESOPs probably could not survive in a competitive environment in which rival firms offered such plans. Yet the market system did not develop ESOPs voluntarily. These plans came into existence solely as a result of regulatory prodding. This alone raises an initial question about the efficiency claims made by ESOP proponents.

This Part examines more closely the claimed virtues of ESOPs and suggests that the supposed benefits are illusory. Where

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82 See, e.g., R. Frisch, ESOP For The '80s 10 (1982) ("ESOPs are already creating millions of new capitalists without taking anything from those who now own capital. As ESOPs proliferate, they may become the major hope for preserving our capitalistic system and perhaps ultimately, our democratic way of life"); Johnson, Employee Stock Ownership, Ripon Q., Summer 1975, at 34 ("shall we revitalize the private enterprise system with employee stock ownership and real social security that owners of private capital can provide?"); 129 Cong. Rec. S16,629-30 (daily ed. Nov. 17, 1983) (statement of Sen. Long)("if we want this private property system of ours to succeed, we simply must insure that as many Americans as possible have an opportunity to earn an ownership stake in that system").

83 See, e.g., Sheppard, supra note 9, at 1270-71; see also R. Frisch, supra note 82, at 8-10 for an optimistic view of ESOPs as the first step in a comprehensive plan to broaden the ownership of capital and thereby cure a litany of perceived economic woes, including inflation, low productivity, employee disgruntlement, foreign competition, high interest rates, disregard of the arts, and unionization.

84 See supra note 21 and accompanying text.
ESOPs do provide workers with true benefits, they are purchased by all taxpayers through foregone revenue, and thus do not provide the kind of income redistribution that is generally claimed. Moreover, the tax incentives cause distortions in the economy that may lead to inefficient behavior.

A. ESOPs Lead to Increased Savings and Investment

Some supporters praise ESOPs because they lead to increased savings and investment.\(^5\) While it is true that ESOP legislation will increase savings tendencies among participants, it does so only in a manner that creates a number of undesirable tax-induced distortions in the behavior of firms.

To see how ESOP legislation fosters increased saving, consider the behavior of a worker ("W") in the absence of taxes. Suppose W, who has earned $100, is indifferent towards consuming now or at the end of time period one when his $100 will have earned a ten percent rate of return, or ten dollars. An income tax may distort W's marginal decision in favor of immediate consumption.\(^6\) If W is subject to a fifty percent tax rate, it will take $200 to cover W's consumption needs, but $200 is insufficient to produce $110 at the end of time period one, because a tax is imposed on both the earning of the $200 and the periodic payments accruing to the $100 saved or invested. This payment of $200 to W will allow him to have only $105 at the end of time period one. If he was indifferent before taxes, W will now choose immediate consumption. Multiplying this distortion by millions of taxpayers leads to less savings than is optimal.

If W receives his compensation in the form of a contribution to an ESOP of $200 worth of employer securities, W will owe no taxes now, but will be fully taxed upon withdrawal at the end of time period one. At a ten percent rate of growth and a fifty percent tax rate, W will be taxed on $220 and will end up with $110 for consumption purposes. Therefore, W will remain indifferent between consumption now or consumption later. The taxation of contributions to ESOPs is perfectly consonant with

\(^5\) See supra text accompanying notes 4–6.
\(^6\) This static equilibrium model assumes that the imposition of a tax does not affect interest rates. Changes in interest rates due to taxes can affect the amount of distortion.
the basic principle of a consumption tax—to eliminate distortions discouraging savings and investment.\textsuperscript{87}

To the extent that the treatment of ESOPs moves the tax system towards a consumption tax, it is likely to encourage savings and investment. Indeed the Internal Revenue Code now contains a welter of provisions that depart from strict income tax principles. The deferred compensation provisions,\textsuperscript{88} the provision authorizing Individual Retirement Accounts,\textsuperscript{89} and the accelerated depreciation provisions\textsuperscript{90} all head the current system towards a consumption tax. The problem with this piecemeal march towards a consumption tax is that, while the legislation may redress some distortions, it creates others.\textsuperscript{91}

Because ESOP legislation provides tax incentives when compared with cash compensation and other pension plans, on the margin we will observe firms setting up ESOPs where, in the absence of tax incentives, compensation would not have been paid with the employer’s stock. In light of the Congressional mandate for a variety of restrictions and rules before an ESOP can qualify for preferential tax treatment, firms may alter their behavior in order to comply.

ESOP provisions are only available to certain corporations.\textsuperscript{92} Businesses operated as partnerships or sole proprietorships cannot avail themselves of the tax subsidized loan privileges available to an ESOP or the rollover privilege available to shareholders on the sale of the employer’s stock to an ESOP.\textsuperscript{93} Marginal firms that favored a noncorporate form of operation before ESOP legislation may now favor incorporation even though the corporate form may result in some deadweight loss

\textsuperscript{87} See, e.g., I.R.C. § 401 (1982); see also supra note 21.

\textsuperscript{88} See, e.g., I.R.C. § 219 (1982).

\textsuperscript{89} See, e.g., id. § 168.

\textsuperscript{90} See, e.g., id. § 167.

\textsuperscript{91} Commentators looking at our tax system inevitably find themselves confronting the theory of “second best.” Crudely summarized, the theory holds that since our tax system is full of provisions that promote inefficiencies, it is impossible to prove that a particular tax change that would be more efficient in a vacuum will lead to greater efficiency in our actual crazy-quilted system. See Lipsey & Lancaster, The General Theory of Second Best, 24 REV. ECON. STUD. 11, 12 (1956).

\textsuperscript{92} Because an ESOP by definition must invest in employer stock, only corporations may establish ESOPs. See I.R.C. § 4975(e)(7) (1982). Even some corporations may be precluded from creating an ESOP. For example, a subchapter S corporation will lose its status if invested in by a trust. Id. § 1361(b)(1)(B). Professional corporations in most states will be denied the ESOP route because of state laws prohibiting investment in the corporation by nonprofessionals. See Kaplan & Ludwig, supra note 1, at A-10 to A-11.

\textsuperscript{93} I.R.C. § 4875(e)(2) (West Supp. 1985).
to society.94 If this was the worst distortion caused by ESOP legislation, the benefits of shifting towards a consumption tax might outweigh any disadvantages. ESOP funding limitations, however, cause more fundamental distortions.

The ceiling on contributions to an ESOP is measured by employee compensation levels. An employer may deduct a maximum of twenty-five percent of an employee’s annual compensation.95 If the amount allocated to the account of a participant exceeds the lesser of twenty-five percent annual compensation or $30,000, the plan will be disqualified and will not be eligible for favored tax treatment.96 Consider two firms, X Corp. and Y Corp., each producing the same product, and facing identical costs and prices in the market. They are identical in size and in every other respect except that X Corp.’s production is labor intensive while Y Corp. is capital-intensive.97 The tax advantages associated with ESOPs, including the ability to borrow at tax subsidized interest rates, will give the labor-intensive X Corp. a decided advantage in the market.98

The distortion of ESOP legislation in favor of labor-intensive firms results in the inefficient allocation of investments throughout the economy. To the extent that larger firms achieve efficiencies by using capital to reduce labor costs, ESOP legislation subsidizes smaller, less efficient firms, thus causing overproduction by labor-intensive firms and underproduction by capital-intensive firms.99

94 See generally P. Samuelson, Economics 757-58 (1980). Deadweight loss is the lost output created by not operating at laissez faire optimality due to taxation or some other redistributive scheme.
95 See supra note 50.
97 To make the comparison complete, we should assume that Y Corp. uses capital that has a one-year useful life and is therefore fully deductible in the same way as compensation or that depreciation deductions accurately measure the decrease in value of an asset with a life in excess of one year. But see Lipsey & Lancaster, supra note 91, at 12 (discussing the problem of second best).
98 Again there may be a problem of second best if current tax rules through accelerated depreciation favor capital over labor. See id.
99 Congress was not totally oblivious to the distortions created by ESOP legislation in favor of labor over capital. As part of the Tax Reduction Act of 1975, Congress authorized an additional one percent investment tax credit if the company used its tax savings to fund a specially defined type of ESOP known as a Tax Reduction Act Stock Ownership Plan or TRASOP. See Tax Reduction Act of 1975, Pub. L. No. 94-12, § 301, 89 Stat. 26, 36-45. Congress destroyed TRASOPs in 1981. See Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 331, 95 Stat. 172, 289-96. Strong lobbying from labor interests convinced Congress that TRASOPs wrongly favored capital intensive companies. TRASOPs were replaced with PAYSOPs which offer a tax credit based on the percentage of participants’ compensation contributed to the plan. Id.
Congress’s abdication of equal treatment for capital intensive firms may be temporary
There is not much systematic, empirical evidence available on ESOPs. Furthermore, the dramatic tax advantages created by the Deficit Reduction Act of 1984 may significantly alter the composition of firms availing themselves of ESOPs. What evidence is available confirms our expectations. Based on 1977 tax returns, over two-thirds of the ESOPs in existence were in the trade/service and manufacturing sectors. The evidence suggests that the companies adopting ESOPs were small, labor-intensive operations. Over eighty-three percent of the ESOPs in 1977 had fewer than 250 employees, and over ninety percent had fewer than 500 employees. By comparison, of the 301 TRASOPs in existence in 1977, all had more than one hundred participants and over sixty percent had one thousand or more participants. In contrast to ESOPs, over forty percent of the TRASOPs were in the transportation/utilities industries with an additional thirty-four percent in manufacturing. These capital-intensive industries benefited from TRASOP legislation, which determined tax benefits on the basis of investment rather than payroll.

Similar conclusions can be drawn from a 1983 study of ESOPs conducted by an ESOP trade association. The median number of ESOP participants per firm responding to one survey was 182. Eighty-four percent of the firms responding were closely held. Light manufacturing firms constituted the largest single

if Senator Long has his way. "It is my hope that at some future date the Congress will reexamine the investment tax credit area in light of our experience with ESOPs." 129 Cong. Rec. S16,629–38 (daily ed. Nov. 17, 1983) (statement of Sen. Long).

100 Hoerr, supra note 3, at 94, 102–10.


102 The empirical information that follows is taken from D. Peckman, supra note 11, at 11–17. The statistics that follow are based on those plans with more than 100 participants.

103 Id. at 17. These figures reflect the 600 ESOPs with more than 100 participants, and also the 1142 ESOPs with fewer than 100 participants. Interestingly, over 81% of ESOP plans with more than 100 participants actually had over 2500 participants. This is because a few very large corporations have adopted ESOPs. Id. at 18.

104 Id. at 16–17. Ninety percent of all TRASOP participants were in plans with more than 2500 participants. Id. at 17.

105 Id. It is likely that TRASOPs were used by heavy manufacturers in view of the larger number of participants per TRASOP as compared with ESOPs. Id.


107 ESOP Survey 1983, supra note 19.

108 Id. at 8.

109 Id. at 11.
line of business for firms with ESOPs. Moreover, the highest percentages of employee ownership were present in light manufacturing and construction, typically labor-intensive activities. Heavy manufacturers with ESOPs tended to have smaller proportions of employee ownership, perhaps reflecting their capital intensive nature.

B. **ESOPs Enhance Employee Productivity**

It is clear that employee productivity significantly influences a firm’s profitability. If worker productivity in a particular firm goes up, then, all else being equal, the value of that firm will rise relative to the value of other firms. Seen in this way, the issue of whether ESOPs increase worker motivation and productivity is essentially an empirical question.

The theoretical justification for the notion that ESOPs increase employee productivity is straightforward—stockholders want the value of the firms in which they own stock to go up. As stockholders, employees of firms with ESOPs in theory will work harder so the value of their investment will increase.

A number of empirical studies have attempted to measure the effects of ESOPs on employee productivity. While ESOP pro-

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110 Light manufacturing businesses comprised 28% of the 229 respondents. Id. at 7.
111 Id. at 6. The survey measured only ownership by the ESOP. The findings do not reflect ownership by employees investing in the firm on their own. Id.
112 Id.
114 It is well established that the best way to measure the effects of a particular event on a firm is to compare the firm’s stock performance before and after the particular event. See, e.g., R. Brealey & J. Myers, *Principles of Corporate Finance* 266–81 (1984). If ESOPs increase worker motivation and productivity, then the implementation of ESOPs should have a positive effect on the share prices of firms implementing such plans, all else equal. Empirical studies of the stock prices of firms that have adopted ESOPs are likely to be unreliable, however, because any increase in share value may be attributable to the tax advantages given to such plans rather than to the effect on worker productivity. As a result, the empirical studies on the effects of ESOPs on worker productivity have by necessity used empirical standards inferior to stock performance. In these studies, the effect of ESOPs on such factors as the firms’ earnings, cash flow and book value have been examined. But because of differences in accounting techniques among firms, studies based on such accounting data are inherently unreliable.
ponents have pointed to some of this research as providing compelling evidence that ESOPs are a proven success at raising worker morale, motivation, and output,117 a more balanced view recognizes that “there has been no conclusive evidence . . . indicating that ESOPs serve as powerful employee motivators or effective productivity enhancers.”118 In evaluating the empirical work in this area, it is important to note both the tentative nature of the research119 as well as the directly opposing con-

117 See, for example, Sen. Long’s glowing account of productivity gains in companies that have adopted ESOPs: “On the basis of the research to date, it is clear that companies with employee ownership are likely to be more productive and more profitable than those without, and the more ownership held by employees, the better the performance of the company.” 129 CONG. REC. S16,629, S16,631 (daily ed. Nov. 17, 1983) (statement of Sen. Long).

118 D. PECKMAN, supra note 11, at 43.

119 Thus one study seemed to make a highly favorable assessment of a particular ESOP, only to conclude that:

[i]t is not possible in this preliminary analysis, however, to provide a definitive explanation of this [company’s] recovery or to attach specific weight to the ownership plan itself. Some of the data do indicate that the plan is having positive effects, both direct and indirect. Yet the company has operated during earlier periods (prior to 1969) at levels of profitability as high if not higher than current levels. Furthermore, we cannot say on the basis of this limited analysis that the company is performing better (or worse) than other traditionally owned companies in its industry.

SURVEY RESEARCH CENTER, supra note 116, at 218-19. Regarding its “finding” that ESOPs are associated with higher productivity, this study noted that: “[t]he firms for which we have measures of profit may be select and our analyses are based on correlations that illustrate associations among variables; they do not prove causation.” Id. at 218-19. This study has, nonetheless, been cited as providing firm empirical support for the ESOP cause. See 129 CONG. REC. S16,629, S16,631 (daily ed. Nov. 17, 1983) (statement of Sen. Long).

Research data for several purportedly supportive studies was compiled by mailed questionnaires. Conte & Tannenbaum, supra note 116, at 27; Marsh & McAllister, supra note 116, at 588; Swad, supra note 116, at 753. Firms of course were free to respond or not as they chose. This raises the possibility of a ‘nonresponse bias’ if the respondents are not representative of the group as a whole. See Swad, supra note 116, at 756. It stands to reason that those firms which were more hopeful and enthusiastic about achieving productivity gains through an ESOP would be more likely to respond to such a survey, since, in all probability, only those firms would have attempted to monitor any resulting fluctuations in worker output. Furthermore, “as of the end of 1980, no complete listing (governmental or otherwise) of all companies that have adopted an
conclusions arrived at by different studies. To the extent that validity can be granted to their findings, several studies show a wide variation in the suitability of ESOPs for different industries. This makes the wisdom of using tax incentives to encourage all firms to set up ESOPs—regardless of their line of business—seem dubious at best.

Although ESOPs might appear to raise productivity in certain firms or industries according to some studies, this does not establish that ESOPs are a more efficient method of motivating employees than other worker incentive plans. On the face of it, the argument that an ESOP will necessarily enhance worker productivity is flawed. In firms with ESOPs, the benefit to be derived from an employee's increased productivity does not flow directly to the employee. Any marginal increase in the value of the firm's stock must be shared equally by all of the firm's shareholders. Furthermore, the allocation of stock contributed to an ESOP is not adequately linked to the specific effort of an employee. In a typical ESOP, this allocation is based on employee compensation—a factor that does not accurately reflect individual productivity. In such a plan, stock is allocated to employees ex ante on the basis of their base salary, and not on the basis of their relative contribution to the firm ex post. As such, any incentive effect of the ESOP is minimized. By working harder, an individual employee:

will get only a minute share of the gain from this action. The very fact that the objective or interest is common to or

ESOP had been compiled. Without such a listing it is nearly impossible to identify an unbiased survey sample." Marsh & McAllister, supra note 116, at 588.

A study conducted by the Institute for Social Research at the University of Michigan found that companies with ESOPs were more profitable than those without. Survey Research Center, supra note 116, at 156-57. However, this finding has been flatly contradicted by more recent research. A survey of 102 firms found that ESOP companies were less profitable than non-ESOP companies. See Livingston & Henry, supra note 116, at 501 - 02. Compare Marsh & McAllister, supra note 116, at 619 (increase in productivity) with Comptroller General of the U.S., supra note 116, at 37 (no meaningful evidence of increased productivity). Moreover, a company might show higher profits after adopting an ESOP because of the tax advantages associated with the plan rather than as a consequence of enhanced worker productivity.

Thus, one study noted that both utilities as well as companies and firms engaged in wholesale trade that had adopted ESOPs showed substantially higher increases in productivity than did those firms in the same line of business that had not done so. However, firms with ESOPs in the services, mining and construction industries showed substantially greater decreases in productivity than did their counterparts without ESOPs. Marsh & McAllister, supra note 116, at 615. Another study concluded that "the statistics (on company operating performance) are encouraging for manufacturers and processors. They offer no encouragement for other types of firms." Swad, supra note 116, at 757.
shared by the group entails that the gain from any sacrifice an individual makes to serve this common purpose is shared with everyone in the group. . . . [T]he individual in any large group with a common interest will reap only a minute share of the gains from whatever sacrifices the individual makes to achieve this common interest.\textsuperscript{122}

This phenomenon is known to economists as the free rider problem.\textsuperscript{123} Because any gain from an individual employee’s increased efforts goes to everyone in the group, those who do not work any harder after an ESOP is imposed will benefit from any productivity increases just as much as those who do change their work habits. If ESOP contributions could be structured so as to favor particularly productive employees, these free rider problems would be eliminated. Unfortunately, the anti-discrimination philosophy that pervades the pension and profit-sharing area prevent this. Eligibility must be broad,\textsuperscript{124} and allocations of employer contributions to plan participants must be on the basis of a pre-determined formula.\textsuperscript{125}

Employers who wish to increase productivity by providing individualized incentives for productive workers must use a compensation device other than an ESOP, because attempting to reward particularly productive workers through an ESOP will jeopardize the plan’s tax favored status.\textsuperscript{126} Thus, firms that adopt ESOPs may not do so to promote productivity, but rather to capture the tax benefits.\textsuperscript{127} If ESOPs are to have the effect on

\textsuperscript{122} M. OLSON, THE RISE AND DECLINE OF NATIONS 18 (1982).

\textsuperscript{123} For a discussion of the free rider problem, see R. POSNER, ECONOMIC ANALYSIS OF LAW 351 (2d ed. 1977).

\textsuperscript{124} ESOPs must generally cover a minimum of 70% of all employees. See I.R.C. § 410(b)(1)(A) (1982). An ESOP must be a defined contribution plan that is a qualified stock bonus plan or a combination of a stock bonus plan and a money purchase plan. See id. § 4975(e)(7). A qualified stock bonus plan must contain a "definite pre-determined formula for allocating the contributions made to the plan among the participants." Id. Contributions are also fixed under a money purchase plan. See Treas. Reg. 1.401-1(b)(1)(i) to (iii) (1982).

\textsuperscript{125} See infra note 133.

\textsuperscript{126} See supra text accompanying notes 31–32.

\textsuperscript{127} On this point, as on so many others, the empirical literature is uncertain. See, e.g., supra note 119. The Institute for Social Research at the University of Michigan found that employers who had implemented ESOPs were heavily influenced in this decision by their expectation that ownership would provide “an incentive for employees to work harder,” or at least more conscientiously. This factor appeared to weigh more heavily than any other in the deliberations over whether to adopt an ESOP. SURVEY RESEARCH CENTER, supra note 116, at 170–71. Ninety-four percent of the responding companies in another survey believed that improving the productivity of employees was either a “very important” or “somewhat important” motivation for adopting an ESOP. Marsh and McAllister, supra note 116, at 602.

Other studies, however, have concluded that management is notably unimpressed
productivity that their proponents hope for, the anti-discrimination requirements must be deleted.

The free rider problem associated with the imposition of ESOPs may induce certain employees to work even less than before in the hope that other (greedier) employees will work harder and keep the overall wage level the same. An important implication of this is that the free rider problem becomes more acute in larger firms than in smaller firms. As a firm becomes larger, the effects of increased efforts on the part of an individual employee become smaller. As such, all else being equal, we would expect larger firms to be less likely to develop ESOPs and instead to search for alternative schemes for compensating employees. Empirical observation does not refute the free rider argument; not only does the incidence of ESOPs decline as firm size increases, but the extent of employee coverage "tends to decrease as company size increases."

with the motivational potential of ESOPs. Only six percent of the respondents in one survey "felt that ESOPs were 'very important' in increasing productivity," while 59% either felt that ESOPs were "not too important" or of no consequence whatsoever in this regard. William M. Mercer, Inc., Employer Attitudes Toward Compensation and Employee Productivity 12-17 (1980). Another study concluded that "most employers were not primarily concerned with ESOPs as a tool for enhancing employee morale or increasing productivity," noting that "[e]mployers had not attempted to determine what impact the ESOP was having on employees and could not provide any measure of increased productivity resulting from the plans." Comptroller General of the U.S., supra note 116, at 39, 42.

While the free rider problem limits the effectiveness of ESOPs as a means of raising worker productivity within large companies, various other features of these plans make ESOPs unsuitable for a broad range of other firms as well. For example, in 1975 the U.S. Railway Association commissioned a report to determine whether an ESOP should be formed for the employees of the Consolidated Rail Corporation (Conrail). That study recommended against the adoption of a plan, noting that a sizable proportion of Conrail's employees were over the age of 50. The report cited motivational research demonstrating "that older employees tend to be more interested in retirement income than in capital accumulation," and concluded that "the ideal situation for implementation of an ESOP is one in which [among other factors] . . . [t]he employee group is either heavily weighted with younger employees or only lightly weighted with older employees." U.S. Railway Ass'n, supra note 116, at 692, 697.

To date, the majority of the firms that have adopted ESOPs are smaller, closely held firms. If ESOPs are going to have any effect on the economy and the nation, large publicly held corporations will have to adopt them. This is where the majority of the nation's wealth is held. Therefore, if ESOPs are to make a significant contribution to the economy's capital needs, they will have to be attractive to large publicly held corporations.

Marsh & McAllister, supra note 116, at 591-92. Only 15% of the private companies in this survey employed more than 500 workers, although private companies accounted for 81% of the firms in the total sample. Id. at 589-92. See also supra text accompanying notes 103 and 108.
Shareholders have strong incentives to increase the productivity of the employees in the firms they control. Shareholders will be expected to invest in greater productivity until the cost of such investment is equal to the benefit to be derived from the increased output. Without the aid of tax incentives, the market has developed numerous methods of inducing workers to increase productivity. Those compensation methods that tailor compensation to individual productivity are more successful than those that do not. To the extent that the tax system favors ESOPs as opposed to these other methods, particularly those that really do reward productivity, economic distortions are created.

There are significant efficiency costs to a regulatory system that exalts one particular market solution over others. The market mechanism itself is a discovery process. Even if the proponents of ESOPs are correct that employees need a stronger sense of association with the firms where they work, the intervention of the state serves as an imperfect substitute for the

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132 For instance, executive compensation plans designed to encourage managers to maximize their firms value are both "wide-spread and becoming more popular. In 1970, 65% of medium-size and larger U.S. manufacturing companies had annual bonus plans, while in 1980, 90% of these firms had such plans." Smith & Watts, Incentive and Tax Effects of Executive Compensation Plans, Austl. J. of Mgmt., Dec. 1982, 139, at 140. The many management incentive plans in place in American industry today include: bonus plans, stock options, stock appreciation rights, restricted stock plans, phantom stock plans, dividend units, etc. Id. at 140–43. For other workers there are a panoply of merit salary increases, piece rate incentive systems, individual bonus plans, sales commission schedules and profit sharing plans. Beer & Spector, supra note 131, at 139–46. The considerable amount of experimentation and diversity in this area plainly belies the impression many ESOP proponents give that firms must be bludgeoned into adopting programs that are designed to increase employee productivity. See, e.g., Marsh & McAllister, supra note 116, at 554. "Thousands of additional companies must be coaxed into either adopting an ESOP or expanding an existing one" if the "ambitious goals" of ESOP proponents for "improving the American economic system" are to be met. Id.

133 Perhaps the best known exposition of this view is to be found in the works of Friedrich A. Hayek. See F.A. Hayek, Individualism and the Economic Order (1948); The Constitution of Liberty (1960); 1 Rules and Order (Law Legislation and Liberty) (1973); See also I. Kirzner, Entrepreneurship, Choice and Freedom, in Perception, Opportunity, and Profit: Studies in the Theory of Entrepreneurship 225, at 238 (1979).

The market process allows for a much greater use of information, as individual producers, consumers, suppliers, and financiers, etc., are left free to act on the knowledge that is available to them, adapting to changing circumstances as they judge best. Thus, new product lines will be introduced, new financing arrangements will be devised and more effective employee incentive plans will be implemented as the need arises.
spontaneous market process of discovery. The market process is likely to produce the best method for compensating workers. The preferential tax treatment afforded to ESOPs "may generate new (unintended and undesired) processes of market adjustments that produce a final outcome even less preferred than might have emerged in the free market."\(^\text{134}\) This distortion of the normal process by which alternative incentive systems are developed will penalize the more innovative firms that might develop new, as yet unthought of, incentive systems. It will also harm those larger firms for which ESOPs are less attractive than alternative systems. These larger firms benefit less from the favorable treatment given ESOPs than do smaller firms. These smaller firms in turn may have adopted ESOPs of their own volition, without the need for tax incentives. Some larger firms, even in the face of tax advantages, might prefer bonus plans or other methods of incentive compensation. To give ESOPs favorable treatment is to give a regulatory preference to those firms that have a comparative advantage in offering ESOPs.

Presumably even those who believe that the market systematically undercompensates workers would prefer that the most efficient alternatives available be used to correct this market failure. But ESOPs are a particularly inefficient method of correcting undercompensation.

C. Employees Want Stock Ownership in Their Employers

Underlying ESOP legislation is an unspoken assumption that employees want to hold their employer's stock as part of their portfolios. However, absent distortions created by the tax system, employees would not be likely to invest a substantial portion of their earnings in the firm for which they work. This stems from the fact that "investors, though seeking high expected returns, generally wish to avoid risk."\(^\text{135}\) The evidence of investor risk aversion is "overwhelming."\(^\text{136}\) Assuming that employees, when acting as investors, will not prefer taking risks to any


\(^{136}\) Id. For example, it is commonplace that investors receive a lower rate of return on bonds than they do on common stock that they might own in the same company. R. Posner, supra note 123, at 320.
greater extent than other investors, portfolio theory strongly suggests that rational investors will prefer diversified portfolios of securities to portfolios that are not diversified. 137 This fact is so well established that as a general rule, pension fiduciaries are required to diversify the holdings they control. 138 However, not only are ESOPs exempt from the fiduciary duty to diversify, ESOP trustees are forbidden to diversify. 139 ESOPs must "invest primarily in qualifying employer securities" in order to qualify for tax favored status. 140

Portfolio theory 141 can be easily summarized. 142 The two salient features of any investment portfolio are its expected return and its riskiness. 143 If all else is equal, investors will maximize return for a given level of risk and minimize risk for a given level of return. 144 The implication of Markowitz's work is that it is possible to construct efficient portfolios based on three factors: (1) the expected return of every security; (2) the variance (or standard deviation) of each return from the mean return of all investments; and (3) the relationship between the return for each individual security and the return for all securities. 145

Building on Markowitz's work, later financial economists recognized the importance of distinguishing between the two types of risk that are associated with stock ownership. 146 Non-systematic or firm-specific risk refers to risk associated with a particular firm. 147 The prospect that a firm's product will become obsolete, or that its managers will steal from the corporate coffers are examples of firm-specific risk. Systematic, or non-firm-specific risk refers to risk associated with the market generally. 148 Con-

137 See Markowitz, Portfolio Selection, 7 J. Fin. 77 (1952).
139 See supra notes 26–28 and accompanying text.
141 See supra note 137. Portfolio theory has its origins in this celebrated article.
143 J. Lorie & M. Hamilton, supra note 135, at 172.
144 Id. at 173.
145 Id. at 172.
147 Id. at 76.
148 Id.
tractions in the money supply and uncontrolled government spending are examples of market risk. Non-systematic risk can be eliminated by diversification. 149 Empirical studies on the relationship between diversification and risk further suggest that rational investors will diversify; for example, a ten stock portfolio will reduce investor risk by eighty-seven percent as compared to a one stock portfolio. 150

There is no meaningful justification for the requirement that ESOPs invest primarily in employer securities. One possible explanation for the existence of the requirement is that those who crafted ESOP legislation wanted to increase employee motivation by giving employees an ownership stake in the future of their firm. 151 Given the free rider problems associated with such motivational schemes, however, this explanation is unsatisfying. 152 As explained above, if employee stock ownership was such an effective way of improving worker motivation, there would be no need to promote the concept through the tax system. 153

Another explanation is that the investment requirements are designed to force employers to share ownership with employees. 154 Yet the need for employees to diversify their investments as do other investors is particularly acute because so much of their economic well-being is already tied exclusively to the firm for which they work. Employees are unable to diversify away the risk to their employment that unforeseen developments will threaten the viability of the firm for which they work. All employees, especially executives and managers, "are undiversified risk bearers who invest their services in only one firm at a time." 155 Because of the simple inability of people to work for more than one firm at a time and the tendency of workers to develop industry-specific and often firm-specific skills, corpo-

149 See Ambachtsheer & Ambrose, Basic Financial Concepts: Return and Risk, in Managing Investment Portfolios, supra note 142, at 47. "As more securities are added to the portfolio, total risk falls at a decreasing rate. At the limit, unsystematic risk becomes zero (because of perfect diversification) and the only risk remaining is that associated with the market in general." See also Modigliani & Pogue, supra note 146, at 78.
150 R. Brealey & S. Meyers, supra note 114, at 112.
151 See supra text accompanying notes 113–15.
152 See supra text accompanying notes 122–25.
153 See supra text accompanying notes 83–90.
154 See supra text accompanying notes 16–19.
rate employees are especially inefficient risk bearers.\textsuperscript{156} It is far more efficient to place the firm-specific risks associated with stock ownership in the hands of those who are able to minimize such risk through diversification. Thus, there is a compelling need for corporate employees to diversify their investment holdings away from the firm and industry to which their human capital is tied.

All of this is another way of saying that where an ESOP holds an undiversified portfolio of employer stock for the benefit of a firm's employees, that stock is worth less to the employees than the same amount of the stock would be worth in the hands of investors who are able to diversify. It is not surprising, therefore, that substantial tax subsidies are needed to induce workers to accept compensation through an ESOP. Thus a major distortion created by the favored treatment given ESOPs is the shift away from the natural market bias towards diversified portfolios.

D. ESOPs Promote Wealth Redistribution

ESOPs are expected to transform the United States into a more productive and more egalitarian country. Proponents wish to rectify the current distribution of stock ownership in this country, where less than ten percent of the United States population holds over seventy percent of the market value of individually owned stock.\textsuperscript{157} ESOPs are touted as a mechanism for renouncing the "Nation's crippling legacy of concentrated ownership."\textsuperscript{158}

However, even putting aside the effects of any production distortions caused by ESOPs, it is not clear in what direction ESOP legislation redistributes wealth. Any wealth transfer generated by ESOP tax benefits is not a direct transfer from shareholders to workers, but rather comes from taxpayers in general and flows to a variety of advantageously situated parties. Since the beneficiaries of ESOPs often may be a firm's more affluent employees, the wealth transfer may be from less wealthy taxpayers to more wealthy employees, thereby leading to a greater concentration of wealth.

\textsuperscript{156} Id. at 871.
\textsuperscript{157} 129 CONG. REC. S16,630 (daily ed. Nov. 17, 1983) (statement of Sen. Long (D-La.).)
\textsuperscript{158} Id.
A second, related problem occurs because managerial agents, such as ESOP trustees, are able to use ESOPs for their own ends rather than for the benefit of their principals, the employee-shareholders. Typically, market forces do much to align the interests of principals with the interests of their agents, but the high costs of monitoring and evaluating managerial performance prevent "anything like a total convergence of interest" between agents and principals. This gap between the interests of agents and their principals is known as "agency cost." Top echelon managers inevitably will have their own reasons for establishing ESOPs, which may be unrelated to the interests of either the employees or the shareholders. The implication is that the establishment of an ESOP may not benefit the employees who are the ostensible beneficiaries of the plan. Rather, an ESOP is more likely to benefit both incumbent management, who can use the plans to fend off unfriendly acquirors, and selling shareholders, who can take advantage of rollover provisions to delay

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159 See infra notes 160–79 and accompanying text.

160 Kraakman, supra note 155, at 863. Kraakman also states: [U]nless these managers are also principal shareholders, their interests will not dovetail with those of the shareholders. Managers' interests will instead depend on the corporation's return to their own specialized 'investment' of time, skill and reputation. Thus, managers will manage with an eye to increasing their own expected utility by maximizing future compensation including salary, job tenure, promotion prospects, informal perquisites, and opportunities for consuming leisure and other goods on the job.

161 Jensen and Meckling define agency cost as "the sum of: (1) the monitoring expenditures by the principal," i.e., the costs involved in "measuring or observing the behavior of the agent," as well as "efforts on the part of the principal to 'control' the behavior of the agent through budget restrictions, compensation policies, operating rules, etc.;" (2) "the bonding expenditures by the agent," those resources expended by the agent "to guarantee that he will not take certain actions which would harm the principal, or to ensure that the principal will be compensated if he does take such actions;" and (3) "the residual loss," the dollar equivalent of the reduction in welfare experienced by the principal due to . . . [the] divergence between the agent's decisions and those decisions which would maximize the welfare of the principal." Jensen & Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305, 308 (1976).


163 One commentator concluded: It is evident that the employee stock ownership plan as conceived by Kelso is designed primarily for the benefit of the employer-corporation. Its main function is to permit the employer to obtain the use of employee trust funds on highly favorable terms. ESOP proponents also invariably stress the many ways in which an employee stock ownership plan can be exploited to accomplish the business and financial objectives of management and stockholders; benefits for employees, if mentioned at all, are viewed as at best incidental and at worst an annoying necessity.

Carlson, supra note 162, at 294–95.
paying capital gains tax. This agency cost problem is magnified because many of those affected by the plan have no say in whether the plan is established. While employees are free to leave firms that shift wage payments from cash to stock ownership through ESOPs, the non-diversifiable, firm-specific human capital investments that employees frequently make impose heavy costs on those employees who wish to leave. These "agency cost" aspects of ESOPs all combine to exacerbate the distortion caused by the tax system and negate the attempt to use ESOPs as a wealth transfer device.

The above concerns are best illustrated by the use of ESOPs in leveraged buyouts, where an investor (often existing management) acquires a controlling interest in a company through the use of borrowed money. The lender generally requires the borrower to pledge as collateral for the loan the assets of the firm whose shares are being acquired. When firm management arranges for the company ESOP (which management may effectively control) to make the acquisition, serious conflicts between the public shareholders and the employees can arise.

The leveraged buyout of the Parsons Corporation by its ESOP illustrates this conflict. The Parsons ESOP borrowed $518 million to purchase all of the outstanding Parsons stock for $32.00 per share. Prior to the buyout, the company was publicly held, but insiders owned substantial blocks of stock. The current employees acquired ownership of the firm through the ESOP; however, these employees were not even entitled to vote on the proposed buyout. Such a vote is required only if the ESOP owns a majority of the stock in the company.

At the time of the leveraged buyout, the firm's stock was trading for $27.50 on the New York Stock Exchange. Mr. William E. Leonard, the firm's chairman, received $5.6 million for his 175,207 shares. The leveraged buyout resulted in total

164 See infra notes 185–230 and accompanying text.
165 Neither ERISA nor any other regulations require shareholder approval for creating an ESOP. See I.R.C. § 422A(b)(1) (1982).
166 For a description of a typical transaction, see Ronan, supra note 1, at 118.
167 See infra text accompanying notes 168–75.
169 Id.
170 I.R.C. § 409(e)(3) (West Supp. 1985). See Ronan, supra note 1, at 129. This fact further undercuts the argument of ESOP proponents that these plans give employees more control over the firms for which they work. For proposed changes in this area, see infra text accompanying notes 245–55.
payments to company executives of $19 million.\textsuperscript{172} Several employee groups have filed formal complaints with the Labor Department charging that under the plan the employees were forced to acquire ownership of the company.\textsuperscript{173} As disenfranchised owners, these employees will have all of the risks of ownership but no voice in how the company will be run.\textsuperscript{174}

As the Parsons situation illustrates, leveraged buyouts by ESOPs are extra-market transactions which provide the employee-purchasers with none of the safeguards inherent in typical going-private transactions. Where, as in the Parsons transaction, the management trustees are also large shareholders (or are influenced by large shareholders), conflicts of interest cannot be avoided. The management trustees are causing the ESOP to purchase their stock at above-market prices, frequently to avoid being taken over by rival management teams.

In the absence of market forces, the only protection given to ESOP participants is the fiduciary duty owed by the management trustees to the purchasing employees.\textsuperscript{175} But in the case of ESOPs, even this ad hoc protection has been significantly reduced. Fiduciary duties prohibit most pension plans from purchasing stock from interested parties such as employers, major shareholders, officers and directors.\textsuperscript{176} Such restrictions, which are part of the general fiduciary rules of ERISA, would prevent ESOPs from engaging in leveraged buyouts, but are inapplicable to ESOPs.\textsuperscript{177} This ESOP exemption is justified by ESOP supporters as facilitating transfers of stock ownership from the current owners to workers.\textsuperscript{178} This Article suggests that this exemption is harmful to the economic interests of the very employees it ostensibly benefits.\textsuperscript{179}

There is a third reason to doubt that ESOPs are an effective means to redistribute wealth. Because large publicly held corporations are less likely to have ESOPs than small closely held firms,\textsuperscript{180} in reality "very little capital is likely to pass into em-
ployees hands as a result [of ESOPs]. More probably the effect will simply be to lighten the income tax burden of the corporations involved and that of their shareholders and executives, at the expense of the rest of us."

Because ESOPs may well protect the interests of managers and more affluent employees rather than those rank and file workers, these devices should prove to be a far less important vehicle for reallocating wealth than advocates claim, despite considerable regulatory support.

**E. ESOPs Preserve Businesses and Jobs**

If the present value of a firm's future income stream is less than its asset value on liquidation (accounting for liquidation costs), it is inefficient to artificially prop up these companies. Society would be better off if the assets of such companies could be redeployed. To the extent it prevents such firms from failing or workers from losing jobs, ESOP legislation perpetuates another market distortion. ESOP defenders, though, often credit ESOP legislation for saving firms and preserving jobs, as when the Chairman of the House Subcommittee on Economic Stabilization opened proceedings on ESOPs by commenting that "[t]his morning's subcommittee hearing is for the purpose of learning about employee-owned companies and particularly about companies which would have shut down had the employees not purchased them and kept them operating." The subcommittee then heard testimony on the use of ESOPs to bail out companies whose market value as going concerns was less than their asset values on liquidation. One such story involved the South Bend Lathe Company, on the verge of liquidation, which was purchased by its employees through an ESOP. The purchase was made possible with the help of a $5,000,000 loan from the federal government to the ESOP at a highly subsidized three percent interest rate.

Similarly, the Canterbury Printing Company established an ESOP which purchased all of the stock from its one hundred

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181 Carlson, supra note 162, at 314.
183 Id. at 4-9.
184 Id. at 5.
percent owner. As Senator Long commented, "As is often the case, Mr. West was looking for a way to reward his many loyal employees who might otherwise have lost their position by a sale to another entity." Why would the employees have lost their jobs upon a sale? Would they be replaced by more efficient workers? Even if that was the case, there may be little objection to continued inefficiency if the workers were willing to subsidize their own inefficiency by accepting lower wages or a lower return on their investment. But objections should arise when the inefficiency is subsidized by other taxpayers through ESOP tax incentives.

For example, Rath Packing Company, a nationally known meatpacker specializing in pork products, lost over $20,000,000 during the 1970's. In order to remain competitive, Rath needed $4,500,000 for modernization. An investor offered to purchase the company, but the proposal would have required workers to accept enormous wage and benefits cuts. As an alternative, the union presented its own proposal to purchase the company through an ESOP. The purchase was coordinated with $7,500,000 of subsidized government loans. While some temporary wage concessions were made, the union essentially avoided market-required concessions through a combination of direct governmental loan subsidies and indirect tax subsidies provided by ESOP legislation.

In a dynamic economy, efficiency demands that some businesses should be liquidated because the assets of those businesses are more valuable in alternative uses. For other firms, greater efficiency will be achieved by selling the business to new owners who will make changes, including, in some cases, firing

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185 The loan was made indirectly from the federal government through the City of South Bend to the South Bend Lathe Company. As part of the plan, the Economic Development Administration made a $5,000,000 grant to the City of South Bend. Id. at 5.


187 To the extent that ESOP participants are blessed with favorable tax treatment, there will be a tax revenue shortfall that will burden taxpayers in general. See, e.g., Hearings, supra note 15, at 108. Another type of subsidization takes the form of government loans at below market interest rates, such as the three percent rate grant to South Bend Lathe Company. See Subcomm. Hearing, supra note 182, at 5.

188 This account is drawn from Olson, Union Experiences with Worker Ownership: Legal and Practical Issues Raised by ESOPs, TRASOPs, Stock Purchases and Cooperatives, 1982 Wis. L. Rev. 729, 753–60 (1982). The article contains similar rescue tales for a variety of companies including Chrysler, Ford, and Pan Am. See id. at 772–80.

workers or cutting wages. These facts have not escaped Senator Long, yet he still attempts to justify ESOP legislation as necessary for workers and communities who "must cope with swollen welfare rolls, and deficits, overburdened State and local relief efforts . . .". Thus, Senator Long champions ESOPs as a governmental second best solution to a host of problems created by other government subsidies.

Proponents of ESOP legislation seem trapped between the recognition that the tax benefits often represent a wealth transfer from taxpayers in general to those taxpayers who own and/or work at inefficient firms and the belief that inefficiency is not being subsidized:

[a] company that is not market responsive, a company that cannot meet its competition and turn a profit should not put its employees in the position of owning that company. ESOP-type financing is not intended for losers. It is intended, however, for those losers and for those marginally profitable firms who, with employee ownership, can become winners.

Two difficulties arise with this reasoning: first, ESOP-type financing may not be intended for losers, but it is available for losers to perpetuate inefficiency; and second, if a loser can become a winner through employee ownership or any other type of change, there is no need for a tax incentive to bring the change about.

That there will be no market for the stock of a truly profitable company or that holders of such stock will be unable to borrow in order to pay estate taxes seems a bit implausible. One explanation may be that what proponents refer to as "profitable" companies are not so regarded by the market. Proponents often try to support this explanation by citing case studies showing how ESOP-owned firms rose from the ashes to prosperity, but counterexamples abound. Rath Packing Company's employee buyout was attended by great publicity in 1980, but today the

190 As Senator Long remarked,
Mr. President, as any free market economist will tell you, it is the essence of capitalism to allow—indeed, encourage—financial capital to seek its highest return. It is this "invisible hand" that serves as the driving force of a market economy. By that measure plant closings make perfectly good economic sense, particularly to those financial managers hired to oversee that capital on their behalf.

191 Id. at S16,637.
192 Id.
company is undergoing bankruptcy reorganization in a Chapter 11 proceeding.\(^{193}\) Even if some studies are true \textit{ex post}, they do not vindicate government intervention \textit{ex ante}. Profitability and efficiency are not necessarily synonymous. Simply stated, a firm with assets that produce a five percent return on investment uses those assets inefficiently if the assets can produce a nine percent return in some alternative use. A firm that seems to be profitable after an employee buyout may not be sufficiently profitable in the eyes of the market, given the risk level of the firm’s activities. Moreover, this “profitability” of ESOP-owned firms is often purchased with the general taxpayers’ dollars.

III. ESOPs AND THE MARKET FOR CORPORATE CONTROL

The market for corporate control, also known as the takeover market, is the arena in which competing managerial teams vie for the right to manage corporate resources.\(^{194}\) Increasingly, ESOPs are being adopted as a defensive technique by managerial teams seeking to avoid takeovers.\(^{195}\) This move clearly illustrates that agency costs may allow management to manipulate ESOPs in the interest of self-preservation but at the expense of shareholders.\(^{196}\)

In an important review article,\(^{197}\) Michael Jensen and Richard Ruback conclude on the basis of dozens of independent studies that corporate takeovers “generate positive gains” and are therefore wealth-creating transactions.\(^{198}\) A takeover can occur

\(^{193}\) Levin, \textit{supra} note 3, at 30, col. 5.

\(^{194}\) The seminal article is Manne, \textit{Mergers and the Market for Corporate Control}, 73 \textit{J. POL. ECON.} 110 (1965); \textit{see also}, McNider, \textit{What is a Tender Offer?}, 37 \textit{WASH. & LEE L. REV.} 908 (1980); \textit{supra} text accompanying note 163.


\(^{196}\) \textit{See supra} text accompanying notes 161–76.


\(^{198}\) \textit{Id.} at 47. On the basis of 13 studies, Jensen and Ruback concluded that “estimates of positive abnormal returns to targets of successful tender offers in the month or two surrounding the offer . . . are uniformly positive ranging from 16.9% to 34.1%, and the weighted average abnormal return . . . is 20.1%.” \textit{Id.} at 10. Moreover, those returns continued “through completion of the offers. Targets of unsuccessful tender offers earn significantly positive abnormal returns on the offer announcement and through the realization of the failure. However, those targets of unsuccessful tender offers that do
through merger, tender offer or proxy contest. Sometimes elements of all three are involved in one corporate control transaction. In many cases, a firm’s incumbent management is not willing to relinquish its managerial responsibilities and therefore takes steps to ensure that the right to manage corporate resources does not fall into the hands of a rival management team. Where this is anticipated, the rival management team will most likely launch a “hostile” tender offer for the shares of the firm it wishes to manage. In these situations the target firm’s management can use the ESOP to inhibit the rival firm from gaining control. To a much lesser extent, the acquiring firm can use the financing advantages available through ESOPs to make the acquisition less costly.

Tender offers can benefit shareholders of both the target and the acquiring firm. The shareholders of the target benefit because they can sell their shares at a premium over the current market price. The bidder’s shareholders can benefit by obtaining the difference between the new value of the firm and the payment to the old shareholders. The increases in wealth that fuel the market for corporate control stem from two primary sources. First, the target firm may be controlled by an inefficient management team; when control shifts, the new management

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199 \textit{Id.} at 6.
200 Where incumbent management does not wish to lose control, acquirors prefer hostile tender offers to mergers because a merger requires approval of the target firm’s board of directors, while no such approval is needed for a tender offer. See, e.g., \textit{Model Business Corp. Act} §§ 71 (merger), 79 (sale of assets) (1969); \textit{Del. Code Ann. tit. 8, §§ 251 (merger), 271 (sale of assets) (1983 & Supp. 1984).}

Hostile tender offers are preferred over proxy fights because the latter are often uneconomical:

Corporate law and economics combine to make the proxy fight an unattractive . . . mechanism for displacing incumbent management. As a practical matter, incumbent management may use corporate resources to resist the challenger’s candidacy. The challenger, however, must use its own funds, which are unlikely to be reimbursed if the challenge fails.


201 See \textit{infra} text accompanying notes 216–38.

202 See \textit{infra} text accompanying notes 239–44.

team may more capably run the business.\textsuperscript{204} Second, synergy gains may result from a combination of the particular assets of the two firms.\textsuperscript{205} In either case, the parties to the transaction benefit, and society's resources are allocated in a more optimal manner.

Managers of a firm that is the subject of a takeover attempt may take steps to avoid being acquired even when they believe that the acquisition will be in the best interests of the shareholders of the firm. This is because a frequent consequence of a successful takeover attempt is the replacement of incumbent management.\textsuperscript{206} Because there are "serious and unavoidable conflicts of interest inherent in any decision on one's own ouster," commentators have asserted that "courts ought not make available to a manager resisting a tender offer—and, in effect fighting against his own replacement—the same deference accorded to the decisions of a manager in good standing."\textsuperscript{207}

In spite of these conflicts of interest, courts generally invoke the business judgment rule to shield the defensive conduct of managers who fight against hostile tender offers.\textsuperscript{208} However,

\begin{quote}
\textsuperscript{204} See Manne, \textit{supra} note 194, at 112.

While it is well established that the share prices of target companies rise after a successful takeover, often quite dramatically, \textit{see supra} note 198, it is difficult, if not impossible, to isolate and identify all the causes for the increases in particular cases. Nonetheless, a number of studies have concluded that "[t]he long history of negative abnormal returns for . . . acquired firms is consistent with the hypothesis that these firms had been poorly managed." Ellert, \textit{Mergers, Antitrust Law Enforcement and Stockholder Returns} 3 J. Fin. Econ. 715, 728 (1976); \textit{see also} Asquith, \textit{Merger Bids, Uncertainty, and Stockholder Returns}, 11 J. Fin. Econ. 51, 82–83 (1983); Malatesta, \textit{The Wealth Effect of Merger Activity and the Objective Functions of Merging Firms}, 11 J. Fin. Econ. 155, 177–80 (1983).

To the extent, then, that an ineffective managerial group is able to entrench itself by using an ESOP defensively, share prices are likely to decline.

\textsuperscript{206} Even managers who have been able to extract a commitment from the acquiring firm of continued employment with the company will have strong incentives to resist a takeover. These include the foreseeable loss of "power, prestige, and the value of organization-specific human capital" for the old management team once the target firm has been absorbed into another corporation. Jensen & Ruback, \textit{supra} note 197, at 8.

\textsuperscript{207} Easterbrook & Fischel, \textit{supra} note 203, at 1198.

\textsuperscript{208} The business judgment rule recognizes that courts generally are not competent to make business decisions and that their involvement in the day-to-day running of firms
\end{quote}
this use of the business judgment rule has come under considerable attack.\textsuperscript{209}

There is much debate about which defensive tactics\textsuperscript{210} are most appropriate to achieve the widely agreed upon goal of maximizing shareholder and societal wealth. The best way to achieve this goal is to ensure that neither side is given an in-

and corporations would, as such, be counterproductive for all concerned. See generally Arsh, The Business Judgment Rule Revisited, 8 Hofstra L. Rev. 93 (1979); Lynch, The Business Judgment Rule Reconsidered, 17 Forum 452 (1981). Only when there is evidence of self-dealing, or some other conflict of interest on a director's or officer's part, will the business judgment rule give way to the stricter "duty of loyalty" standard, which scrutinizes corporate officers' transactions with their companies to determine whether they are "unfair to the corporation." See Marsh, Are Directors Trustees?: Conflict of Interest and Corporate Morality, 22 Bus. Law. 35, 43 (1966). One judicial formulation of the rule provides that:

[Directors of corporations discharge their fiduciary duties when in good faith they exercise business judgment in making decisions regarding the corporation. When they act in good faith, they enjoy a presumption of sound business judgment, reposed in them as directors, which courts will not disturb if any rational business purpose can be attributed to their decisions. In the absence of fraud, bad faith, gross overreaching or abuse of discretion, courts will not interfere with the exercise of business judgment by corporate directors.


For cases applying the business judgment rule to directors' actions in the corporate control context, see Panter v. Marshall Field & Co., 646 F.2d 271, 294 (7th Cir. 1981), cert. denied, 454 U.S. 1092 (director's decision to resist tender offer, which would have allowed target shareholders to sell their stock at a substantial premium, protected under the presumption that corporate officers will act in good faith); Treadway Companies, Inc. v. Care Corp., 638 F.2d 357, 381 (2d Cir. 1980) (director's issuance of corporate stock to "white knight" not a breach of fiduciary duty in the absence of any affirmative showing of bad faith); Johnson v. Trueblood, 629 F.2d 287, 292 (3rd Cir. 1980) (decision not to tender stock to minority shareholders, if at least arguably made for the benefit of the corporation, protected under the business judgment rule).


Influential commentators have stated that "every economically-sophisticated commentator" has advocated the outright ban of defensive tactics. 1983 S.E.C. Advisory Comm. on Tender Offers Rep. of Recommendations 70, 100 (separate statement of Frank H. Easterbrook and Gregg A. Jarrell).

appropriately advantage over the other in a battle for control of a corporation. The Williams Act, the major federal legislation affecting tender offers, takes the position that there should be a "level playing field" as between bidding firms and target firms. Regardless of one's views as to the efficacy of such legislation, it is agreed that the success or failure of takeover rules should be judged on the basis of whether they achieve the goal of evenhandedness.

ESOPs may be used by corporations both as a "shield" to counter unwanted takeover attempts and as a "sword" to facilitate the acquisition of other firms. In either case, to the extent that firms without ESOPs are on the other side of these transactions, distortions inevitably arise. The remainder of this Part evaluates more fully the nature of these distortions. Analyzing the tax provisions relating to ESOPs and observing how ESOPs have been used in actual control transactions reveals that ESOPs are significantly more valuable to incumbent management teams than to outsiders in battles for corporate control. In this regard, the rules and practices relating to ESOPs are in conflict with the general premise articulated in the federal securities laws, that the legal system should not favor one group over another in control transactions.

A. ESOPs as a Shield

Perhaps the most obvious use of ESOPs in corporate control transactions is by an incumbent management team that establishes an ESOP to acquire stock in its own firm for the purpose

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211 Securities Exchange Act of 1934, §§ 13(d)-(g), 14(d)-(f), 15 U.S.C. §§ 78m(d)-(g), 78n(d)-(f) (1982).
212 In its opinion in Piper v. Chris-Craft Industries, 430 U.S. 1 (1977), the Supreme Court noted that in enacting the Williams Act, "Congress was indeed committed to a policy of neutrality in contests for control," and held that the "sole purpose" of that legislation "was the protection of investors who are confronted with a tender offer." Id. at 29, 35. In Edgar v. Mite Corp., 457 U.S. 624 (1982), the Court re-emphasized that: it is also crystal clear that a major aspect of the effort to protect the investors was to avoid favoring either management or the takeover bidder . . . . As the legislation evolved, therefore, Congress . . . expressly embraced a policy of neutrality. As Senator Williams explained: "We have taken extreme care to avoid tipping the scales either in favor of management or in favor of the person making the takeover bids."
Id. at 633.
213 See infra text accompanying notes 216–38.
214 See infra text accompanying notes 239–44.
215 See supra notes 211–12 and accompanying text.
of thwarting the acquisition plans of an unwanted suitor. The ESOP's acquisition of stock serves to dilute the voting strength of the acquiror's block of stock and increases the amount of stock an acquiror must acquire to obtain control. \footnote{See, e.g., Klaus v. Hi-Shear Corp., 528 F.2d 225, 228 (9th Cir. 1975) (target company guaranteed loan to ESOP that enabled ESOP to purchase 50,000 newly issued shares, after offeror had obtained approximately 45% of target's stock); Texas International Airlines, Inc. v. Continental Airlines, Inc., No. 81-5514 (9th Cir., June 18, 1981) (affirming denial of preliminary injunction; after offeror obtained 48.5% of the target company's outstanding shares, the target set up an ESOP and guaranteed loans for it up to $185 million for the purchase of newly issued stock).}

This strategy is particularly attractive to management where there is significant overlap between the board of directors of the target company and the trustees of the ESOP. \footnote{See, e.g., Donovan v. Bierwirth, 538 F. Supp. 463, 465-66 (E.D.N.Y. 1981), aff'd as modified, 680 F.2d 263 (2d Cir. 1982), cert. denied, 459 U.S. 1069 (1982).}

The tax provisions associated with ESOPs make it possible for firms to finance such stock acquisitions at subsidized rates. \footnote{See infra notes 219-26 and accompanying text.}

Institutional lenders extending loans to enable an ESOP to acquire the employer's securities are allowed to exclude from income fifty percent of the interest received on such loans. \footnote{I.R.C. § 133(a) (West Supp. 1985).}

Consequently, the interest rate a lender charges an ESOP will be lower than the rate charged for a comparable non-subsidized acquiror, and the ESOP will have relatively more money to spend on stock purchases. \footnote{See supra text accompanying notes 58-59, 71-72.}

The rollover provision of the Deficit Reduction Act of 1984 provides a particular advantage to the target firm. Prior to 1984, any gain realized by a seller on the sale of employer securities to an ESOP was taxed to the seller at normal capital gains rates. \footnote{I.R.C. §§ 61, 1202, 1222 (1982).}

The 1984 Act changed this to permit any person who sells employer stock to an ESOP to elect to defer the capital gain realized if the proceeds from the sale are used to acquire the stock of a domestic corporation. \footnote{I.R.C. §§ 1042 (a) and (c)(3) (West Supp. 1985).}

This provision gives target firms a clear advantage over rival bidders in the acquisition of shareholder stock. If an ESOP is willing to pay the exact same price for stock as a rival bidder, selling shareholders will elect to sell to the employer-controlled ESOP in order to defer the payment of capital gains taxes. Even where the rival bidder...
is prepared to pay more for the stock, the preferred capital gains treatment given to the ESOP's purchase may result in the rival, which values the firm more, losing a control battle to the incumbent management team. Where this occurs, the favorable tax treatment afforded ESOP purchases of employer stock results in an inefficient allocation of resources.

While the rationale for the rollover provision was to shift the ownership structure of corporations away from large individual stockholders and towards ESOPs and worker control, an unintended consequence is strongly to favor incumbent management in battles for corporate control. ESOPs could be encouraged to acquire employer stock without distorting the market for corporate control simply by restricting favorable tax treatment to sales of non-voting stock. In this way employees could acquire an economic interest in the firm for which they work without giving unwarranted advantages to incumbent management. Such a rule would conform to many of the articulated goals that underlie the favorable treatment given to ESOPs, but would not distort the market for corporate control. Yet the restrictions actually imposed on sales of employer stock to ESOPs are precisely the opposite of those suggested here; deferral of capital gains treatment is only permitted on employer common stock that has voting power equal to or in excess of that class of employer common stock that has the greatest voting power. This voting provision exacerbates the distortions created by the rollover provisions on the market for corporate control.

Incumbent management also may use ESOPs to prevent loss of control by causing the ESOP to make purchases of employer stock well in advance of the announcement of a hostile tender offer. If management creates an ESOP and it begins acquiring stock after a hostile tender is launched, it seems particularly likely that the purpose of the ESOP is to thwart a shift in control. And where it can be shown that the primary purpose of the ESOP is to evade a change of control, the ESOP will be struck

224 See supra text accompanying notes 82–83. Of course, allowing ESOPs to purchase non-voting stock would not give employees any control over management of a company. But the primary advantages of ESOPs cited by proponents occur by giving employees a financial stake in the economic performance of a company, not by giving them voting control. See id.
225 See supra notes 2, 82–83 and accompanying text.
226 I.R.C. §§ 1042(a)(1) and 409(f) (West Supp. 1985).
A graphic illustration of how ESOPs may be used in this respect and how courts will treat such plans arose in *Norlin v. Rooney Pace*. Piezo Electric Products, Inc. and Rooney Pace, Inc. (Piezo's investment banker) began buying large blocks of stock in the Norlin Corporation. To prevent these firms from gaining control of the corporation, Norlin created an ESOP and caused it to purchase newly created Norlin common and preferred voting stock. The trustees of the ESOP were all members of the Norlin board of directors, and voting control of the ESOP was retained by the directors. In an action to enjoin Norlin from voting the common stock, the Second Circuit refused to accord the decisions made by Norlin the deference typically given to managers under the business judgment rule because the transaction was tainted by self-interest. Evidence of management self-interest was found in the fact that the board offered its shareholders no rationale for the transfers other than its determination to oppose a shift in control at all costs. In addition, the ESOP was created only five days after a district court had refused to grant Norlin an injunction against further stock purchases by Piezo, “at a time when Norlin’s officers were clearly casting about for strategies to deter a challenge to their control.” As is typical in cases where the target firm issues shares to an ESOP shortly after a challenge to corporate control, the court found that the transfer of shares to the ESOP “gives rise to an inference of improper motive.”

While actions taken subsequent to the tender offer are likely to be struck down, “if actions can be taken prior to a tender offer, the risk of such theories being successfully asserted can

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228 744 F.2d 255 (2d. Cir. 1984).
229 See id. at 259.
230 See id. at 259.
231 The court noted that:

the business judgment rule governs only where the directors are not shown to have a self-interest in the transaction at issue . . . . Once self-dealing or bad faith is demonstrated, the duty of loyalty supersedes the duty of care, and the burden shifts to the directors to ‘prove that the transaction was fair and reasonable to the corporation.’

Id. at 265.
232 Id.
233 Id. at 266.
234 See supra note 227 and accompanying text.
235 Id. at 266 n.10.
be significantly reduced provided there are other legitimate purposes for implementing or maintaining an employee benefit plan that owns employer stock."236 While there is often little doubt that the true purpose of the ESOP is to lower the probability of a future shift of control, it is clear that ESOPs established before the announcement of a hostile tender offer are much less subject to attack. This is so because: (1) it is "difficult for the offeror to prove that such actions taken before a tender offer were taken to fend off an unfriendly offer instead of for legitimate corporate purposes;"237 (2) it is easier for ESOP trustees to show compliance with their fiduciary duties if actions are taken before the tender offer; and (3) courts are more likely to accept the explanation that other legitimate purposes exist for the ESOP if it is established in advance of the tender offer.238 Thus, while courts will occasionally step in to prevent incumbent management from using an ESOP solely as a means to retain corporate control, ESOPs generally can be a significant impediment to takeovers.

B. ESOPs as a Sword

At first blush it may seem as though ESOPs do not distort the market for corporate control because the plans may be used by both the acquiror and the acquired firm. Just as the target may establish an ESOP in order to borrow money at subsidized rates, buy its own stock and thereby acquire its own shares, so also a raider may set up an ESOP to acquire shares in the target. The acquiror causes the ESOP to borrow money from a bank (also at subsidized rates), and uses this money to purchase its own shares. The proceeds from the sale of stock to the ESOP may be used by the acquiror to purchase shares of the target firm. The acquiror generally will be required to guarantee the ESOP's bank loan and make periodic contributions to the ESOP to enable it to repay the loan, but it also will receive a tax deduction for these contributions.239

While it may seem that ESOPs provide advantages to both target firms and raiders, there are a number of factors that make ESOPs more useful to target firms than to acquiring firms in the

236 Brecher, Lazarus & Gray, supra note 195, at 504.
237 Id. at 513.
238 See supra text accompanying note 236.
239 See supra note 51.
battle for corporate control. First, because management of the
target firm typically controls the ESOP, it controls the "float"
or number of shares that the target firm has outstanding. The
outsider must locate shares in the open market and purchase
them above the current market price. As the Norlin case illus-
trates, incumbent management does not have to rely on market
purchases, but can cause the ESOP to purchase previously
unissued shares. Thus, while the acquiror may find it difficult
to acquire shares at the market price because the supply of such
shares is inelastic, the target has no such problem because it
can simply (and literally) print the additional shares it wants to
purchase.

Second, even where the target firm and the raider are both
bidding for shares owned by current shareholders, the rollover
provisions of the Deficit Reduction Act of 1984 give selling
shareholders a strong economic incentive to sell to the target
firm rather than to the acquiror. Selling to the target firm's
ESOP enables the selling shareholder to avoid paying capital
gains taxes on the sale. Thus, while ESOPs are becoming a
potent weapon in the arsenal of incumbent management seeking
to retain control of their firm, these plans have not proved as
useful to management teams attempting to obtain control.

IV. COMPREHENSIVE TAX REFORM AND ESOPS

The call for tax simplification and reform is in the air. Ac-
cordingly, one might expect the inefficient and technically com-
plicated ESOP provisions to be eliminated. Indeed, President Rea-
gan's "Tax Proposals to the Congress for Fairness, Growth and
Simplicity" ("Proposal") notes some of the problems with the
current ESOP provisions: "Despite the intentions behind [the
ESOP] provisions, they represent a confused mix of incentives
and requirements which fails to encourage direct employee own-
ership . . . . Indeed, if participation in the ESOP is in lieu of
current compensation, such deferral [of benefits] may actually

240 The board of directors of the target company in Norlin transferred 185,000 shares
of the firm's common stock to its newly created ESOP. See Norlin, 744 F.2d at 259.
241 See, e.g., Klaus v. Hi-Shear Corp., 528 F.2d 225, 225 (9th Cir. 1975); Texas
242 See supra note 54.
243 See supra text accompanying notes 54–56.
244 See supra text accompanying note 54.
lessen employees’ overall incentive to increase productivity.”245 The Proposal goes on to point out that the vesting requirements and contribution and distribution limits associated with retirement plans, when applied to ESOPs, “unnecessarily restrict the ability of an employer to provide the benefits of owning employer securities to its employees.”246

Notwithstanding these enunciated reasons for change, the Proposal would preserve the ESOP concept, albeit in a revised set of provisions. Curiously, the proposal never justifies the preservation of the ESOP concept.

The thrust of the changes incorporated in the Proposal is to provide employees with greater control over stock received pursuant to the ESOP provisions.247 “Direct ownership of employer securities, with the attendant rights and benefits, is far more likely to be an incentive for employee productivity than a speculative benefit to be realized only upon separation from service.”248 Consequently, the Proposal requires the employee stock ownership trust to distribute annually to participants a portion of the securities held by the trust as well as all dividends paid during the year.249 Employees would not have taxable income upon distribution of securities from the trust.250

245 President’s Tax Proposals to the Congress for Fairness, Growth and Simplicity, 72 STAND. FED. TAX REP. (CCH) 315 (extra ed. May 29, 1985) [hereinafter cited as Proposal].
246 Id. at 316.
247 Id. at 316–17.
248 Id. at 318. In addition to the changes discussed infra at text accompanying notes 249–63, the Proposal would repeal the special deduction limits available to a leveraged ESOP and replace them with provisions allowing a deduction up to 25% of aggregate employee compensation for principal payments on a loan taken out by the employer to purchase stock contributed to an employee stock ownership trust. To qualify for the 25% limit, the yearly principal payments must be between 8.3% and 20% of the original principal balance, or equal and amounting to a complete payoff in 10 years or less. See Proposal, supra note 245, at 316. The special exception for ESOPs to the prohibited transaction rules would be repealed as would the provision allowing an ESOP to assume a decedent’s estate tax liability. See Proposal, supra note 245, at 317–18.
Stock must be distributed to employees in accordance with their respective compensation amounts, with amounts over $50,000 disregarded. The employee would be entitled to a put-option beginning three years after stock is distributed and continuing for a specified period of time each year thereafter. Dividends paid by the employer would still be deductible, but a corresponding nondeductible payment to the employee receiving the dividend would be required in an amount offsetting the tax saving. Id.
249 Proposal, supra note 245, at 316–17. The portion is equal to scheduled principal repayments for the leveraged ESOP stock for the year. The Proposal does not indicate what must be distributed in the case of a non-leveraged ESOP.

The Proposal does allow a trust agreement to imbue the trust with nominal ownership of the securities so long as the employees had all rights of direct ownership, including the right to receive dividends, the right to vote, and the right to transfer the securities. Id.
250 Proposal, supra note 245, at 317.
The distribution of securities has several implications. First, future dividends made on the distributed securities go directly to the employee-shareholder. Second, the employee-shareholder could vote on all corporate matters. Third, and probably most important, employee-shareholders could choose to diversify their investments by selling their shares in the open market.

In addition, an employee-shareholder may be able to take advantage of the deferral provisions enacted as part of the Deficit Reduction Act of 1984. Accordingly, the ESOP beneficiary could sell the employer securities to the employee stock ownership trust and reinvest the proceeds in a timely fashion in securities of another corporation, thereby postponing any recognition of gain.

In its analysis of the suggested revisions, the Proposal notes:

> Employees should receive the benefits of owning the stock currently, including the right to decide whether the employer securities are an appropriate investment, rather than being required, as under current law, to maintain an investment in the employer through the ESOP. If ownership of employer securities is a sound investment, the employees will readily agree to continue that tax deferred investment and work to enhance its value. On the other hand, if the employer stock is a bad investment, employees should enjoy the same freedom to dispose of it as any other rational investor. Employees are poorly served where the tax law overrides their own judgments.

Providing employee-shareholders with the freedom to diversify their portfolios is wholly consistent with the criticisms leveled in this Article at existing ESOP provisions. However,

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251 Under the existing provisions, it is not required that beneficiaries of the employee stock ownership trust vote on all corporate matters. See supra text accompanying note 43.

252 The present requirement that ESOPs invest "primarily" in employer securities severely restricts the diversification potential of the plans. See supra text accompanying notes 135–57.

Under the Proposal, an employer would be required periodically to grant employees the right to "put" the securities to the employer at their fair market value, starting three years after receipt. See Proposal, supra note 245, at 317. The seller essentially would have ordinary income on that portion of the sales proceeds equal to the fair market value at the time of distribution and capital gains on any excess. Id.

253 See supra text accompanying note 55. It is not clear if the Proposal would permit an employee to use the rollover provision. I.R.C. § 1042(c)(1)(C) (West Supp. 1985) contains a caveat that securities acquired under a "qualified plan" are not eligible for rollover treatment. But see Proposal, supra note 245, at 319.

254 The basis in the newly purchased securities would preserve the unrecognized gain. See supra note 55.

255 Proposal, supra note 245, at 319.

256 See supra text accompanying notes 135–56.
the Proposal grants freedom in a convoluted and costly manner—one that maintains existing distortions. Even with the Proposal's liberalized grants of sovereignty to employee-shareholders, the ESOP provisions would retain many of their distortive features in the nature of tax advantages: loans to employee stock ownership trusts would remain subsidized through an interest exclusion for the lender;\textsuperscript{257} gain on stock sold to an employee stock ownership trust could still be deferred while deferral is unavailable for stock sales in general;\textsuperscript{258} dividends on ESOP stock would still be deductible by the employer while dividends on non-ESOP stock are not deductible;\textsuperscript{259} and ESOP benefits would still favor labor rather than capital investment.\textsuperscript{260}

In fact, a far more effective mechanism for promoting worker capitalism would be available with some modest revisions in the existing laws governing individual retirement accounts. Suppose, for example, that an employee received $100 in cash from X Corporation (X Corp.). This amount would be fully taxable. The employee could purchase stock of X Corp. pursuant to the individual retirement account (IRA) provisions.\textsuperscript{261} The tax consequences of such a purchase would be a $100 deduction offsetting the $100 of income. The same tax consequences result if the employee purchased securities of Y Corporation instead of X Corp. In such a case, the same opportunities for increased worker capitalism are available through the simple operation of IRAs as through the labyrinthian ESOP provisions. Full enjoyment of those advantages would require some modifications of

\textsuperscript{257} See Proposal, supra note 245, at 317. See also supra text accompanying notes 58–74 (explanation of the interest exclusion).

\textsuperscript{258} See Proposal, supra note 245, at 317; see also supra note 253. Retention of the rollover feature introduced by the Deficit Reduction Act of 1984 perpetuates the imbalance between target and acquiror companies discussed supra at text accompanying notes 221–24.

\textsuperscript{259} The Proposal attempts to ensure that the benefits of that deduction are passed on in their entirety to the employee-shareholders by conditioning the deduction on an additional nondeductible cash payment to ESOP recipients equal to the tax saving from the deduction. Proposal, supra note 245, at 317–18. Regardless of the Proposal's attempt, the way that the dividend deduction is divided between employer and recipient is a function of the demand and supply curve for labor. For example, if the supply curve for labor is very inelastic, granting a tax benefit for dividends paid to employee-shareholders will largely benefit the employers. The converse is true if the supply curve is elastic. Where Congress legislates who is to receive the benefit of the deduction, the employer and shareholder-employees will find other ways to reach market equilibrium. If the market has an elastic labor supply curve, other compensation will be lowered to offset the legislated payment. See also supra note 72.

\textsuperscript{260} See supra text accompanying notes 95–112.

\textsuperscript{261} See I.R.C. § 219 (1982). I am treating I.R.C. § 219 at this point as if it did not contain its restrictive provisions. See infra text accompanying notes 264–68.
existing IRAs. The deduction currently available to taxpayers contributing to an IRA is limited to $2000, with an additional $250 for a spousal IRA. The Proposal would increase the spousal IRA to $2000, thus permitting an overall $4000 deduction per joint return. If the IRA concept replaced the ESOP provisions as well as other special tax incentives aimed at increased investment, other restrictions would have to be eliminated. For example, the deduction limits, even as increased under the Proposal, should be eliminated. In addition, the restrictions on premature withdrawal should be eliminated so that taxpayers can move in and out of investments as the market dictates.

Eliminating the ESOP provisions in favor of expanded IRA provisions would be efficient in at least two respects. First, the costs of implementation and enforcement of the complex ESOP provisions would be eliminated. Second, the distortions discussed in this Article associated with the ESOP provisions would be eliminated.

V. CONCLUSION

Tax subsidized ESOPs cause significant market distortions for little benefit, but they are not alone in this regard. Our criticisms of the ESOP provisions are equally applicable to a host of other isolated provisions that provide tax benefits in order to encourage investment under an income tax system that promotes consumption over investment. Our preferred response to these criticisms is movement to a consumption tax which would in principle allow a deduction for savings and investment. Broadening the IRA provisions is consistent with that response and would obviate the need for the existing welter of deferred

263 See Proposals, supra note 245, at 340–41.
264 For a description of the restrictions and requirements associated with IRAs, see Lipsig, Individual Retirement Arrangements [1984] TAX MGMT. (BNA) No. 355.
265 See Proposals, supra note 245, at 317–18.
266 See I.R.C. § 408(f) (1982).
267 See supra text accompanying notes 23–49 for a discussion of ESOP requirements.
268 See supra text accompanying notes 84–193.
270 See supra text accompanying notes 4–5 and 84–91.
271 See R. HALL & A. RABUSHKA, supra note 4; Doemberg, supra note 4.
compensation arrangements, each with their special tax advantages and concomitant economic distortions. Moreover, the heart of the ESOP provisions—the deduction to the employer and deferral by the employee-shareholders—can be realized through the already existing IRA concept without the distorting tax advantages presently associated with the ESOP provisions.

Would expanding the IRA provisions (or adopting a full fledged consumption tax) lead to greater worker capitalism and productivity, a goal of ESOP proponents? This is, of course, a complicated question. But there is a direct, revealing response. Workers given cash compensation will vote with their dollars. Some dollars will go to current consumption, some to investments in the employer’s stock and some to outside investments. Just as employees would be free to vote with their dollars, employers convinced that worker productivity does increase with employee ownership could insist on compensating workers in part with the employer’s stock. The market would then determine whether employees would choose such a compensation package or would opt for alternative packages (perhaps all cash) offered by the employer’s competitors.

In any case, it is clear that at any given level of compensation firms will choose that compensation package which attracts the most productive employees. Thus, removing ESOP restrictions will lead to greater worker productivity, if not greater worker capitalism. If worker capitalism is inconsistent with worker productivity, no amount of regulation will cause that inconsistency miraculously to disappear.

The distortion of the taxpayer’s consumption/investment decision which is caused by the income tax could be eliminated by moving to a consumption tax (which would allow a deduction for investment). This, in turn, would eliminate the need for special legislation designed to increase worker productivity and worker capitalism. Unless ESOP proponents can point to some sort of market failure to support the tax policies currently in place, we suggest that employers and employees determine in the free market the appropriate level of employee stock ownership rather than the Congress through tax incentives.

272 See Proposal, supra note 245, at 339–82.
273 See supra text accompanying notes 83–91.