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EMPLOYEE STOCK OWNERSHIP PLANS, VOTING RIGHTS, AND PLANT CLOSINGS*

Congress has enacted many statutes which provide tax incentives for the transfer of a corporate employer's stock to its employees.[1] One of these, the Employee Retirement Income Security Act of 1974 (ERISA),[2] provides for the creation of special employee benefit arrangements called Employee Stock Ownership Plans (ESOPs).[3] Several hundred corporations have already set up ESOPs for their employees.[4]

After examining the structure and tax consequences of ESOPs, this note will argue that ESOPs should guarantee employees full voting rights[5] over securities transferred to them under such plans. This note will also propose that ESOPs can be used in employee takeovers of corporations as part of a plan to help prevent plant closings.

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[1] Five acts have included special provisions for employee stock ownership plans of various types. *See* Trade Act of 1974, Pub. L. No. 93-618, 88 Stat. 1978 (codified at 19 U.S.C. §§ 2101-2487 (Supp. 1975)) (19 U.S.C. § 2373 (f)(1) (Supp. 1975) authorized the Secretary of Commerce to give a preference to corporations which establish qualified employee stock ownership plans.); Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (codified in scattered sections in the Internal Revenue Code of 1954 and 29 U.S.C. (Supp. 1977)) (Section 802 of the Act extends the investment tax credit for certain corporations' employee stock ownership plans which is authorized in I.R.C. § 46(a)(1).); Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26 (codified in the Internal Revenue Code of 1954 (Supp. 1976).) (I.R.C. §§ 46(a)(1) codifies the investment tax credit for corporations which adopt certain employee stock ownership plans.); Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified in scattered sections of the Internal Revenue Code of 1954 and 29 U.S.C. (Supp. 1976)) (Employee stock ownership plans are defined in I.R.C. § 4975(e)(8).); and Regional Rail Reorganization Act of 1973, Pub. L. No. 93-236, 87 Stat. 985, (codified at 45 U.S.C. §§ 701 *et seq.* (Supp. 1976)). (Employee stock ownership plans are defined at 45 U.S.C. § 702 (Supp. 1976).).

[2] Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified in scattered sections of the Internal Revenue Code of 1954 and 29 U.S.C. (Supp. 1976)) [hereinafter cited as ERISA].

[3] For discussions of the impact of ERISA on the concept of employee stock ownership plans, *see* Note, *Employee Stock Ownership Plans: A Step Toward Democratic Capitalism*, 55 B.U.L. REV. 195 (1975); Note, *Recent Developments in Employee Stock Ownership Plans*, 16 WASHBURN L.J. 709 (1977).

[4] The Internal Revenue Service has acknowledged at least 250 such plans. TIME, Oct. 4, 1976, at 80. A Congressional report estimates that between 200 to 500 such plans have been established. STAFF OF JOINT ECONOMIC COMM., 94TH CONG., 2D SESS., BROADENING THE OWNERSHIP OF NEW CAPITAL: ESOPS AND OTHER ALTERNATIVES 58 (Comm. Print 1976).

[5] *See* notes 27 & 28 and accompanying text *infra*.

I. DESCRIPTION OF ESOPS

An ESOP is a stock bonus plan that qualifies as a tax-exempt, employee benefit trust plan by meeting the requirements of ERISA and the Internal Revenue Code of 1954 (IRC).[6] Although ESOPs are very similar to pension plans, they differ in two important respects. While pensions tend to invest in a variety of securities, the Employee Stock Ownership Trust (ESOT) created by the ESOP must invest "primarily" in "qualifying employer securities."[7] Furthermore, the benefits from the ESOT must be distributed to the employees in the form of securities of the employer corporation rather than in cash, as with other pension plans.[8] Since ESOPs are deferred compensation plans, an employee's interests in ESOT holdings are typically distributed when he terminates his employment with the corporation.[9]

ESOPs must also comply with the general requirements of the IRC which are applicable to all employee benefit plans.[10] Consequently, ESOPS must be set up for the "exclusive benefit" of employees or their beneficiaries.[11] In addition, ERISA requires that each plan be managed by a fiduciary who must act solely in the interests of the employees or their beneficiaries.[12]

The tax consequences of ESOPs are similar to those of other deferred compensation employee benefit plans.[13] Typically, the employer corporation is entitled to deduct from its gross income the fair market value of its

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[6] The basic requirements are outlined in the definition of an ESOP as a contribution plan:

(A) which is a stock bonus plan which is qualified, or a stock bonus and money purchase plan both of which are qualified under section 401(a), and which are designed to invest primarily in qualifying employer securities; and

(B) which is otherwise defined in regulations prescribed by the Secretary or his delegate.

ERISA § 2003(a), I.R.C. § 4975(e)(7). I.R.C. § 401(a) outlines the requirements for employee benefit plans to qualify for tax preferences. The Secretary of the Treasury is primarily responsible for regulations concerning ESOPs, although the Secretary of Labor is also entitled to issue regulations concerning some aspects of ESOPs. ERISA § 407, 29 U.S.C. § 1107 (1975).

[7] "Qualifying employer securities" include stocks, bonds, debentures, notes, and other certificates of indebtedness issued by the employer. ERISA § 407(d)(5), I.R.C. § 4975(e)(8). Most practitioners interpret "primarily" to mean that at least 75 % of the ESOT holdings should be "qualifying employer securities." Bushman, *ESOPs: A Trustee's Perspective*, 115 TR. & EST. 416, 417 (1976).

[8] Fractional shares may, however, be distributed in cash. Treas. Reg. § 1.401-1(a)(2)(iii), (b)(1)(iii), Rev. Rul. 71-256, 1971-1 C.B. 118.

[9] The employee may elect special lump sum distribution tax treatment under I.R.C. § 402(e), or he may receive his distribution as an annuity under I.R.C. §§ 72, 402(a).

[10] In order to be exempted from federal taxation by I.R.C. § 501, a trust which forms a part of a stock bonus, pension, or profit-sharing plan for employees must comply with certain requirements relating to employer contributions, vesting, nondiversion, coverage, nondiscrimination, and forfeitures. I.R.C. § 401.

[11] I.R.C. § 401(a)(2).

[12] ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1) (1975).

[13] For a fuller discussion of the tax implications of ESOPs, *see* Pavlock & Lieberman, *The Taxation of ESOTs* (pts. 1 & 2), 7 TAX ADVISER 68, 132 (1976). *See also* Pavlock & Lieberman, *Employee Stock Ownership Trusts—An Update*, 8 TAX ADVISER 476 (1977); Note, *Recent Developments in Employee Stock Ownership Plans*, *supra* note 3.

contributions to the ESOT up to 15 percent of the compensation of covered employees.[14] Excess contributions may be carried forward or back for additional tax deductions.[15] Income of the ESOT is tax-exempt so long as it continues to comply with the relevant IRC provisions.[16] Moreover, employee interests in ESOTs are not taxed until they are actually distributed.[17]

II. ESOPs and Voting Rights

A. Present Law

Because ESOPs invest primarily in employer securities, the question of who should control the voting of such securities is of particular importance. Presently, the employer securities held by the ESOT need not have any voting rights attached to them.[18] If the securities do have voting rights, they are exercised by the plan fiduciary,[19] who is typically appointed by the board of directors of the employer corporation.[20] Employees are not guaranteed the right to direct the fiduciary's voting of such securities.[21] Thus, the only effective way that employees can gain control over their interests in the ESOT is through collective bargaining negotiations.

In an apparent effort to further protect employee interests, the Internal Revenue Service proposed regulations which would have entitled each employee to direct the fiduciary's voting of any shares of employer securities with voting rights which had been allocated to his individual account.[22] If an ESOT borrowed money to acquire employer securities,

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[14] I.R.C. § 404(a)(3)(A); Rev. Rul. 69-494, 1969-2 C.B. 237 (1969). Contributions may be in the form of cash, stock, or other property. ERISA §§ 406(a)(1)(E), (2), 407(a)(1), 414(a). 29 U.S.C. §§ 1106(a)(1)(E), (2), 1107(a)(1) 1114(a) (1975). For a discussion of the difficulties in valuing contributions of employer securities to ESOTs, *see* Clausen, *ESOP Stock Valuation: A Case for Liquidity*, 115 TR. & EST. 419 (1976).

[15] I.R.C. § 404(a)(3)(A).

[16] A trust described in I.R.C. § 401(a) is exempted from federal taxation by I.R.C. § 501(a). *See* notes 10 & 11 *supra* concerning the various requirements of a trust under I.R.C. § 401(a).

[17] I.R.C. § 402(a)(1). *See* note 9, *supra*.

[18] *See* note 7, *supra*. ERISA § 407 (d)(5), I.R.C. § 4975(e)(8) is the sole provision stipulating the type of securities an ESOT must hold.

[19] I.R.C. § 4975(e)(3).

[20] Most plans provide for a fiduciary appointed by the board of directors to vote the securities or for an administrative committee, also appointed by the board, to direct the fiduciary's voting. Bushman, *supra* note 7, at 434; Knight, *The Increasing Importance of ESOPs in Employee Benefit Planning, Estate Planning, and Corporate Finance*, 12 GEORGIA ST. B.J. 6, 43-44 (1975). Indeed, members of the board of directors may serve as fiduciaries or as members of the administrative committee. Questions and Answers Relating to Fiduciary Responsibility Under the Employee Retirement Income Security Act of 1974, 29 C.F.R. § 2509.75-8 (1975).

[21] ERISA is silent as to employee direction of the fiduciary's voting, though employees may sometimes sit on the administrative committee which directs the fiduciary. Bushman, *supra* note 7, at 434.

[22] 41 Fed. Reg. 31, 833 (1976). The Secretary of the Treasury derives his authority to issue such regulations from ERISA § 2003(a), I.R.C. § 4975(e)(7). *See* note 6, *supra*.

the proposed regulations would have limited the percentage of nonvoting securities which could be purchased.[23] If the ESOT did not borrow money to acquire employer securities, however, the proposed regulations would not have required the ESOT to hold any voting employer securities.[24] Thus, although the proposed regulations would have provided employee control over the exercise of voting rights on employer securities, they would not have guaranteed that all employer shares held by ESOT be vested with voting rights.

Nevertheless, even the limited expansion of employee control proposed by the Internal Revenue Service met with strong opposition from Congress. The Conference Report which accompanied the Tax Reform Act of 1976 specifically criticized the proposed regulations, and expressed the belief that "the usual rules applicable to employee plans properly protect the interests of plan participants."[25] Subsequently, the Internal Revenue Service issued final regulations which withdrew the proposed regulations to expand employee voting rights.[26] Therefore, employees are still not assured of any voting control over employer securities held by ESOTs.

B. The Need for Full Voting Rights

The fundamental policy of ERISA is to protect the interests of employees in their benefit plans.[27] In keeping with this policy, employees should be guaranteed full voting control over all employer securities held by an ESOT. Specifically, each employee should be entitled to direct the fiduciary's voting of all employer securities held by the ESOT on his behalf, whether allocated to his individual account or not.[28]

The proposed regulations provide "that each participant is entitled to direct a designated fiduciary as to the manner in which any employer security allocated to the account of such participant is to be voted."

Proposed Treas. Reg. § 54.4975-11(d)(2)(i), 41 Fed. Reg. 31,837 (1976). They also would have required that voting rights "be exercised only to the extent directed by participants" and that "[a]mounts contributed to an ESOP by an employer . . .be allocated to the account of each participant" by the close of the plan year. Proposed Treas. Reg. § 54.4975-11(d)(2)(iii), (c)(1)(i), 41 Fed. Reg. 31,837, 31,836 (1976).

[23] Specifically, no more than 25 % of such securities could be nonvoting. Proposed Treas. Reg. § 54.4975-7(b)(2)(i)(8)(5), 41 Fed. Reg. 31,835 (1976).

[24] Proposed Treas. Reg. § 54.4975-11, 41 Fed. Reg. 31,836 (1976) is silent on this matter.

[25] H.R. REP. No. 1515, 94th Cong., 2d Sess. 539, 541 (1976), *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 4234, 4236.

[26] 42 Fed. Reg. 44,388, 44,389 (1977).

[27] *See generally* the findings and declarations of policy for ERISA. ERISA § 2, 29 U.S.C. § 1001 (1975). A number of other writers have recognized the need for an approach which would guarantee employees more voting control over ESOT holdings. *See generally* Berman, *Employee Stock Ownership Plans (ESOPs) and Implementation of Worker Management*, 1976 ASSOCIATION FOR SELF-MANAGEMENT NEWSLETTER No. 19, 2; Carlson, *ESOP and Universal Capitalism*, 31 TAX L. REV. 289 (1976); Ditkoff, *The IRS Proposes New Regulations to Reform the Prodigal ESOP*, 54 TAXES 630 (1976); Note, *Employee Stock Ownership Plans: A Step Toward Democratic Capitalism*, *supra* note 3.

[28] Employees should be entitled to direct the voting of unallocated securities in proportion to their interests in the ESOT. Of course, this requirement should apply only to securities which could be voted by the fiduciary. For example, if an ESOT borrows money in order to purchase employer securities, it may have to pledge those securities and their voting rights

1. ESOPs as employee benefit plans—Although ESOPs are basically employee benefit plans, they are not gifts to the employees.[29] Rather, employer contributions to an ESOP are additional labor costs which an employer must pay for employee services.[30] As a result, whenever employees receive an ESOP benefit, they forego other employee benefits. Thus, ESOPs are essentially investments, primarily in employer securities, of employee compensation.[31]

ESOP investments may be more attractive to employees than comparable wage increases because of the deferred taxation of ESOP interests.[32] However, they may be considerably less attractive, economically, than comparably funded diversified investment plans such as ordinary pensions.[33] ESOPs are less attractive because they involve greater risks; that is, for any given rate of expected return, the expected variation in that rate of return is greater for an ESOP than for a diversified investment portfolio.[34] The risks of diversified plans may be further reduced with investment securities which are safer than those of the employer.[35] Thus, an ESOP faces a higher risk of great depreciation in value than does a diversified plan.[36] This higher risk is a direct consequence of the require-

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as collateral for the loan. The ESOT then would not have control over the voting of such shares and thus the requirement of passing through voting rights should not apply to such securities.

[29] Several commentators implicitly view contributions to an ESOT as gifts to employees. Consequently, they erroneously conclude that the value of corporate stock is diluted more by such contributions than by comparable employee benefits. *See, e.g.*, Blum, *ESOPs as Financing Vehicles: Dilution Aspects*, 7 TAX ADVISER 452 (1976); Huene, *Beware the ESOP: A Cautionary Tale*. 7 TAX ADVISOR 722 (1976). As long as a corporation seek profits, however, its contributions to an ESOT will be no more gifts to employees than are wages or ordinary pension benefits. For such a corporation, its contribution to an ESOT will not dilute the value of corporate stock any more than will alternate employee benefits.

[30] Contributions of cash to an ESOT entail costs to the corporation in that present equity is reduced. Even where an employer contributes treasury stock to an ESOT, there will be a real cost to the corporation and its shareholders since future profits must be shared and present per share equity is reduced.

[31] *See* notes 6 & 7, *supra*, for a discussion of ESOT investments in employer securities.

[32] *See* note 17 and accompanying text *supra*. ESOP investments may also be more attractive to management and shareholders than other less flexible forms of employee compensation. For example, an ESOP may be used to create a market for stock of a closely-held corporation. ESOPs also may be used to obtain equity capital, to acquire control of independent corporations, and to increase current tax deductions. *See generally* Knight, *ESOPs Offer Employee Benefits, Corporate Financing and Control, Estate Planning*, 43 J. TAX. 258 (1975); Note, *Employee Stock Ownership Trusts: Tax Advantages for Estate Planning in Close Corporations*, 84 YALE L. J. 1519 (1975); and Carlson, *supra* note 27, at 294-300.

[33] Pension funds are required to diversify their investments. ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C) (1975). ESOPs are specifically exempted from this diversification requirement. ERISA § 404(a)(2), 29 U.S.C. § 1104(a)(2) (1975).

[34] When time is held constant, the riskiness of an investment will decrease as the number of holdings increases. While the marginal decrease in risk resulting from each additional holding becomes negligible as the number of holdings increases above five holdings, diversification can reduce risk substantially up to that point. R. BREALY, AN INTRODUCTION TO RISK AND RETURN FROM COMMON STOCKS 123-32 (1969).

[35] ESOPs, on the other hand, must always invest primarily in employer securities. *See* notes 6 & 7 *supra*.

[36] Indeed, the value of securities in 60% to 70% of corporations actually declines over the life of an employee. Drucker, *Pension Fund "Socialism,"* 42 PUB. INT. 3, 10 (1976). While diversified investments may also depreciate in value, diversification will reduce the average size of such depreciation. *See* R. BREALY, *supra* note 34, at 123-32.

ment that ESOPs invest primarily in employer securities.[37] Since many employees will have much of their savings invested through their corporation's employee benefit plan, ESOPs will usually be less attractive to them than a comparably funded diversified plan.[38]

It has been argued, however, that ESOPs are more valuable to employees than diversified plans.[39] According to this view, ESOT holdings will appreciate faster than diversified plan holdings because employees' beneficial interests in the corporation, wholly apart from any voting rights, will prompt them to work harder, increase their productivity, and thereby earn greater profits for the corporation.[40] Little evidence can be found to support this view, however.[41] Indeed, indirect rewards are generally ineffective in increasing employee productivity.[42] Moreover, unless the ESOT holds a large percentage of the corporation's securities, there is no reason to expect employees to be more productive since most of the increased earnings would go to nonemployee shareholders.[43]

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[37] Drucker, *supra* note 36, at 10, therefore concludes that ESOPs are "financially unsound to the point of recklessness."

[38] Admittedly, diversification also reduces the chance of an investment plan making great gains. It has been argued that employees should gamble their savings in an undiversified portfolio on the chance of such gains. For example, attorney Louis Kelso, the originator of the ESOP idea, sees diversification as "something a rich man does in order not to become poor. A poor man who has nothing loses nothing if it fails but can stand to reap huge rewards if it succeeds." *Quoted in* O'Hara & Crawford, *Will Every Corporation Have an E.S.O.P.? Senator Long Makes it Hard to Say No,* 61 A.B.A.J. 1366, (1975). Actually, employees face a greater chance of losing their retirement savings if they have an ESOP instead of a diversified plan.

[39] *Id.* at 1369; *Employee Stock Ownership Plan (ESOPs): Hearings before the Joint Economic Comm.*, 94th Cong., 1st Sess. (1975), at 689 [hereinafter cited as *Employee Sock Ownership Plans (ESOPs)*] (Submission of the United States Railway Ass'n).

[40] *Employee Stock Ownership Plans (ESOPs), supra* note 39, at 689 (Submission of the United States Railway Ass'n).

[41] *Id.* at 690-91, 787-97 (Submissions of the United States Railway Ass'n). For example, a study of 15 corporations with established ESOPs did not find any convincing evidence that employees became more motivated or more productive. *Id.* at 793. For a rebuttal see *id.* at 263-355 (Submission of attorney Louis Kelso).

[42] *See generally* E. LAWLER III, MOTIVATION IN WORK ORGANIZATIONS (1973). Lawler suggests that economic rewards are effective in increasing employee productivity only when they are closely tied to individual employee performance. That is, the more indirect the reward, the less likely it is that an employee's individual performance will be affected. For example, a machine operator is likely to be far more motivated by a bonus based on the output from his machine than he would be by a stock option plan. The value of a stock option depends upon the productivity of all employees and on the ability of the company to succeed in the marketplace while the employee's bonus is dependent solely upon his individual productivity. Thus, company-wide incentive plans are unlikely to have great effects on employee productivity.

[43] There is evidence that a financial consideration approximating 20% of pay is necessary to secure some increase in employee productivity. Therefore, a substantial percentage of stock would have to be transferred to employees before dividend payments would produce additional compensation sufficient to lead to motivational changes. *Employee Stock Ownership Plans (ESOPs), supra* note 39, at 816 (Submission of John J. Terry, Vice President Financial Planning, United States Railway Ass'n). There is also some evidence that an important correlate of profits is the percent of a company's equity which is owned by its non-managerial employees. Based on a limited sample of companies, it has been found that the greater this percent, the greater the profits of the firm. M. CONTE & A. TANNENBAUM, EMPLOYEE OWNERSHIP: REPORT TO THE ECONOMIC DEVELOPMENT ADMINISTRATION UNITED STATES DEPARTMENT OF COMMERCE PROJECT NO. 99-6-09433 at 2-3 (1977). Other investigators have also found superior employee productivity in corporations fully owned by

Furthermore, even if it is true that ESOPs stimulate higher productivity, employees still face a higher risk of depreciation of their interests than they would face with a diversified plan. The higher risk remains because corporations with ESOPs may still decline or go out of business because of technological change or mismanagement. Thus, even if ESOPs increase employee productivity, it is questionable whether the resulting increased expected return compensates for the high risk inherent in such undiversified ESOP investments.[44]

ESOPs with sufficiently higher expected returns could be more attractive than undiversified plans. One way to boost expected return is to require that full voting rights be passed through to employees, since studies have shown that employee productivity does increase when employees are allowed a greater voice in the management of their corporations.[45] Such a requirement could make it more likely that expected returns would be high enough to offset the greater risks of having an undiversified ESOP investment.

ESOPs which give employees full voting rights may also be attractive to employees because of the intrinsic, non-economic value of voting rights. Since surveys of employee attitudes have shown that many employees desire to have a greater voice in the management of their corporations,[46] voting rights in employer securities may have an inherent psychological value to employees. When this value is also taken into consideration, ESOPs which grant full voting rights may be even more attractive to employees than comparably funded diversified investment.

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employees. *See* K. BERMAN, WORKER-OWNED PLYWOOD COMPANIES: AN ECONOMIC ANALYSIS 189-90 (1967); Bernstein, *Run Your Own Business,* 1 WORKING PAPERS FOR A NEW SOCIETY 24, 26-28 (1974); TIME, Oct. 4, 1976, at 80. Of course, the increased productivity may often be explained by other factors, such as the difference in management approach in employee owned corporations. *See* E. LAWLER III, *supra* note 42, at 120-21.

[44] The primary effect of higher productivity would be to increase the expected value of a corporation's securities. If the ESOT investment remains undiversified, the higher risk of greater depreciation will remain. A substantially higher expected return would be necessary to compensate for the intrinsic value of a more secure investment. Therefore, a greater percentage of the employer securities would have to be transferred to the ESOT to make the gamble worthwhile, especially if most of each employee's retirement savings are involved. *See* note 43 *supra.*

[45] *See generally* E. LAWLER III, *supra* note 42, at 182-83; P. WARR & T. WALL, WORK AND WELL-BEING 86-115 (1975); Brower, *Experience with Self-management and Participation in United States Industry,* in ORGANIZATIONAL DEMOCRACY: PARTICIPATION AND SELF-MANAGEMENT 73 (G. Garson & M. Smith eds. 1976). The percentage of employee held voting shares required to trigger increases in productivity is not certain. It does not seem unreasonable, however, to suggest that this threshold level might be met by the presence of at least one employee representative on the board of directors.

[46] P. WARR & T. WALL, *supra* note 45, at 86-115, documents studies that employees value increased participation in corporate decision-making. Furthermore, a recent public opinion survey conducted by Peter D. Hart Research Associates, Inc., of Washington, D.C., found that most Americans favor giving employees greater control over their corporations. Fifty percent of the people surveyed thought that employee owned and controlled corporations would improve the economy, and 66% thought that it would "do more good than harm" to develop programs whereby employees could gain ownership of a majority of a company's stock. *Small Business and Society: Hearings Before the Senate Select Comm. on Small Business,* 94the Cong., 1st Sess. 3 (1975) (Statement of Sheila Rollins). *See also* J. RIFKIN, OWN YOUR OWN JOB: ECONOMIC DEMOCRACY FOR WORKING AMERICANS 105-77 (1977).

Even if employees have full voting rights, the transfer by a corporation of a small percentage of its securities to an ESOT will give employees little additional representation in corporate affairs and only a small part of the corporate earnings. In such cases, employees probably will not be more productive and will be better off with other kinds of benefits. On the other hand, if a corporation transfers a large percentage of its securities to an ESOT, employees are likely to receive a more valuable benefit since they will acquire some control over the corporation and the right to much of its earnings. Thus, at a minimum, ESOPs should be required to pass full voting rights through to employees.[47] Furthermore, the Congress should consider limiting ESOP tax preferences to those plans which transfer a large percentage of the corporation's securities to the ESOT.[48]

2. *Protection of employee interests*—The guarantee of full voting rights includes the requirements that all employer shares held by ESOTs have voting rights and that employees be entitled to direct the fiduciary's voting of those shares. It may be argued that employees are better off having a competent fiduciary vote the shares without their direction. Since the fiduciary is chosen and serves at the grace of the existing board of directors,[49] however, he may represent management's interests rather than those of the employees.[50] Although an ESOP fiduciary can be sued for breach of his fiduciary responsibilities, such suits may provide only minimal protection for employee interests.[51]

In addition, employees are capable of determining what is in their best interests and voting accordingly.[52] While employees may have difficulty making complex management decisions, they are certainly as competent as other shareholders to decide basic questions of corporate policy and to select the board of directors.[53] Employees have successfully participated

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[47] *See* notes 27 & 28 and accompanying text *supra*.

[48] Congress should allow tax benefits only to those plans which will pass sufficient securities to the ESOT to enable employees to elect at least one member of the board of directors. In addition, plans should not be entitled to tax benefits unless sufficient securities have vested in individual accounts within 10 years of initiating the plan to enable the employees to control the corporation. Finally, employee approval should be required before a plan can be adopted.

[49] *See* note 20 *supra*.

[50] Indeed, some plans are designed to have a "friendly" fiduciary or administrative committee. Knight, *supra* note 20, at 44. Of course, employers can more easily circumvent the interests of employees by transferring only nonvoting securities to the ESOT, *id.* at 44.

[51] Under earlier law the employees had the burden of proving that the fiduciary acted in bad faith, arbitrarily, or fraudulently in order to prevail in such suits. 60 AM. JUR. 2D *Pensions and Retirement Funds* § 78 (1976). The standards of fiduciary conduct under ERISA have not yet been fully developed. *But see* Eaves v. Penn, 426 F. Supp. 830 (W.D. Okla. 1976).

[52] It may be argued that a fiduciary selected by employees or by their collective bargaining representatives could better represent employee interests. While such a mechanism could well give employees as a group greater power, employees are not a homogenous group and probably would not agree on all issues. If employees wish to vote their shares together voluntarily, they should be allowed to do so. However, requiring that employee shares be voted by a labor-selected fiduciary is no better than having them all voted by a management-selected fiduciary. In either case, the employee is being denied the right to direct his own investment in employer securities. There is no compelling reason to treat employee interests in ESOTs differently from the interests of nonemployee shareholders.

[53] Indeed, because of their work experience, they may be better informed about the corporation's operations than the typical shareholder.

in the management of corporations in other countries.[54] Moreover, participation experiments in this country have shown that employees and management can cooperate in formulating corporate policies.[55] Finally, numerous successful corporations in this country are already full owned and operated by their employees.[56] Thus, there is little reason to believe that employees are not at least as capable of directing the voting of employer securities as a fiduciary.

Furthermore, the extension of full voting rights to employees would not conflict with the main purposes of ESOPs.[57] Some corporations might be discouraged from establishing ESOPS if full voting rights are required. Given the undiversified nature of ESOT investments, however, this requirement is necessary to protect the employees' benefit. Nor should it be forgotten that ESOPs are to be set up for the "exclusive benefit" of employees or their beneficiaries.[58] Finally, passing through full voting rights should reduce the amount of conflict between management and employees and lead to a more democratic economy.[59]

These considerations find support in the Internal Revenue Code and at least one state statute, which already encourage some extension of full voting rights to employees. The Tax Reduction Act of 1975 allows corporations to take extra investment tax credits if they make contributions of employer securities to an employee stock ownership trust and allow employees to direct the voting of such securities.[60] Similarly, Minnesota has granted state tax deductions to encourage employee stock ownership plans which grant full voting rights to employees.[61] Thus, there is statutory encouragement for guaranteeing full voting rights to employees.

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[54] In West Germany, for example, there are employee representatives in the management of most large corporations. There is no indication that such participatitn has reduced the profits and productivity of such corporations. *See generally* Woolridge, *The System of Codetermination in Western Germany and its Proposed Reform*, 5 ANGLO AM. L. REV. 19 (1976); Comment, *Codetermination in West Germany*, 51 ORE. L. REV. 214 (1971); Ball, *Hard Hats in Europe's Boardrooms*, FORTUNE, June, 1976, at 180. For a discussion of the implications of the European experiences for United States labor-management relations, *see* Murphy, *Workers on the Board: Borrowing a European Idea*, 27 LAB. L.J. 751 (1976).

[55] *See* note 45 *supra*.

[56] *See* K. BERMAN, note 43 *supra;* Bernstein, note 43 *supra;* J. RIFKIN, note 46 *supra*, at 27-43; M. CONTE & A. TANNENBAUM, note 43 *supra*.

[57] ESOPs have been justified on the grounds that they serve important capital formation and estate planning functions. Knight, note 20 *supra*. Furthermore, attorney Louis Kelso claims that the ESOPs can be used to guide economic planning, achieve economic growth and stability, and promote "universal capitalism." *Employee Stock Ownership Plans (ESOPs)*, *supra* note 39, at 139 (prepared statement of Louis Kelso). While it is questionable whether or not ESOPs actually serve all these functions, maximizing employee voting is not inconsistent with any of them.

[58] *See* note 11 and accompanying text *supra*. In the words of one writer, "[i]t may be far better to have no ESOP at all than an employee benefit plan which benefits only the employer." Ditkoff, *supra* note 27, at 634.

[59] While there might be numerous boardroom fights between management and labor initially, the continued dialogue and the sharing of management functions should lead to greater cooperation. Furthermore, this similarity of purpose should increase as the employees receive more employer securities. *See* M. CONTE & A. TANNENBAUM, *supra*, note 43 at 39-65.

[60] I.R.C. § 46(a)(1). For a fuller discussion of the employee stock ownership plans created pursuant to the Tax Reduction Act of 1975, *see* Carlson, *supra* note 27, at 304-12. *See also* Note, *Recent Developments in Employee Stock Ownership Plans*, *supra* note 3, at 716-18.

[61] MINN. STAT. ANN. §§ 290 *et seq.* (West 1974).

III. ESOPs AND PLANT CLOSINGS

Plant closings and relocations are often accompanied by major social and economic costs. Unemployment due to plant shut-downs is a critical problem for many local communities and their residents.[62] Costs to former cmployees include loss of income and adverse psychological consequences.[63] Costs borne by federal, state, and local treasuries include income maintenance benefits to the newly unemployed and loss of income, sales, and business tax revenues.[64] Although it is clearly in the public interest to reduce these costs, the Federal government has no comprehensive program to deal with plant shut-downs.[65]

Many plants are closed for sound economic reasons. Other plants, which have high profit margins or good prospects for significant long-term growth, are likely to be sold rather than closed.[66] The decision to close or relocate, however, may lead to the liquidation of an intermediate category—economically viable plants.[67] This tendency is indirectly permitted and indirectly encouraged by federal, state, and local government actions. Many states and municipalities induce relocation by providing

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[62] For example, a total of 200,000 jobs were lost in Michigan as a result of plant closures and relocations from 1967 through 1973. *The National Employment Priorities Act: Hearing before the Subcomm. on Labor Standards of the House Comm. on Education and Labor on H.R. 76*, 94th Cong., 1st Sess. 46 (1975) [hereinafter cited as *The National Employment Priorities Act*]. Furthermore, about one-half of the shut-downs occurred in the seven-county Detroit region, where unemployment was already in excess of the State average. *Id.* at 22.

[63] The magnitude of these costs depend largely on whether and how quickly the unemployed can be reabsorbed by the local economy. This, in turn, depends upon the degree of local unemployment, the ability of the employer to transfer employees to other plants, and the skill level and age of the newly unemployed. M. AIKEN, L. FERMAN, & H. SHEPPARD, ECONOMIC FAILURE, ALIENATION AND EXTREMISM 30 (1968). The psychological dangers include alienation, feelings of helplessness, feelings of worthlessness, depression, and possible suicidal tendencies. For an excellent discussion of all costs of individual plant closings, *see* SENATE SPECIAL COMM. ON UNEMPLOYMENT PROBLEMS, 86TH CONG., 1ST SESS., TOO OLD TO WORK—TOO YOUNG TO RETIRE: A CASE STUDY OF A PERMANENT PLANT SHUTDOWN (Comm. Print 1960).

[64] For example, estimated federal and state costs of making unemployment compensation payments and sustaining personal income tax losses for the head of a family of four with income of at least $165 per week in the State of Michigan were at least $3200 for one year in 1977. This estimate does not include other income maintenance or any tax losses. Since former employees of corporations which have shut down may be unemployed for many months, the public sector costs of plant closings can be very high. *See generally* M. AIKEN, L. FERMAN & H. SHEPPARD, *supra* note 63.

[65] A number of Western European countries do have programs to deal with this type of problem. *See The National Employment Priorities Act*, *supra* note 62, at 85-96 (Workers' Rights and Plant Shutdowns, statement prepared by the U.A.W.); *Id.* at 118-126 (Plant Closure and Relocation Laws in Western Europe, statement prepared by the staff of the Library of Cong., Law Library).

[66] While there is no way to estimate how many economically viable plants have shut down, a number of plants which would have closed down had their employees not purchased them are still in operation. The two plants of this group which have had time to establish a performance record seem to be operating successfully. M. CONTE & A. TANNENBAUM, *supra* note 43, at 39-65 (South Bend Lathe Co.); J. RIFKIN, *supra* note 46, at 41-43 (Vermont Asbestos Group).

[67] An economically viable plant may be considered to be one which can meet all of its short-term and long-term obligations. Under this view even plants which generate only small profits must be considered economically viable in that they can sustain their operations over an indefinite period of time.

property tax incentives, loans, and lower pollution and occupational health and safety standards.[68] Moreover, the Internal Revenue Code permits corporations to deduct the costs of relocating as ordinary expenses of doing business, and investment tax credits and accelerated depreciation allowances may actually encourage the closing of viable plants and the opening of new ones.[69] In addition, federal and state labor laws impose no meaningful restrictions on the right of corporations to relocate for economic reasons.[70] Thus, the combined actions of the private market and various levels of government can lead to the closing of some economically viable plants.

ESOPs can serve as the basis for a federal program to reduce the number of plant closings, since ESOPs can be used to enable employees to purchase their plants and keep them operating. This employee buyout mechanism is initiated by first having the employer corporation establish an ESOP. The ESOT then borrows money and purchases all outstanding employer securities in the plant corporation involved.[71] The loan is secured by the ESOT's pledge of all those securities as collateral and by the plant corporation's promise to make sufficient annual contributions of cash to the ESOT to enable it to repay the loan.[72] As the ESOT pays off the loan, the lender must gradually release the pledged securities.[73] In this way the ESOT comes to hold and control all of the outstanding plant securities, and these are allocated to individual accounts. Thus, ESOPs can provide a mechanism for employees to purchase their plant with borrowed funds. Because of the tax advantages of ESOPs, the purchase can be accomplished at lower effective cost to the employees through an ESOP than through a direct purchase.[74]

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[68] *The National Employments Priorities Act, supra* note 62, at 86 (statement prepared by the United Automobile Workers).

[69] *Id.* at 86; *see also* I.R.C. § 162 (business expenses); I.R.C. § 38 (investment tax credit); I.R.C. § 167 (depreciation).

[70] *See* note 68 *supra.*

[71] If the employer corporation operates more than one plant, the plant to be divested should be separately incorporated as a plant corporation.

ESOTs are specifically authorized to borrow money in order to purchase employer securities. ERISA § 408(b)(3), 29 U.S.C. § 1108(b)(3) (1975); ERISA § 2003(a), I.R.C. § 4975 (d)(3).

[72] In most cases collateral for an ESOP loan may consist only of qualifying employer securities. ERISA § 408(b)(3), 29 U.S.C. § 1108(b)(3) (1975).

[73] In general, the loan must provide for the proportional release from encumbrance of plan assets used as collateral for the loan. Treas. Reg. § 54.4975-7(b)(8)(i), 42 Fed. Reg. 44,391 (1977). For example, if 15,000 shares of X stock are pledged as collateral for a 15 year loan payable in level annual amounts, then 1/15th or 1,000 shares must be released in each succeeding year of the loan. Treas. Reg. § 54.4975-7(b)(8)(iv), 42 Fed. Reg. 44392 (1977).

For loans of a 10 to 15 year maximum duration, this requirement poses minimal interference with the employee's takeover of the plant corporation. A gradual release of shares from the lender's encumbrance may even promote the gradual and orderly transfer of control of the plant corporation from management to employee representatives. Loans of a duration of more than 15 years seem to require an unreasonably long time period to transfer control and should be prohibited by statute or regulation.

[74] Since employer contributions to ESOTs are tax deductible (*see* note 14 *supra*), and taxation of employee interests is deferred until distribution, when their tax brackets will probably be lower (*see* note 17 *supra*), the employees can use the ESOP to purchase the corporation with pre-tax dollars. In the alternative, the employees would have to purchase

Unfortunately, sufficient private sector financing for such purchases is not always available to ESOTs.[75] Lenders may be skeptical of the employees' ability to run a company that earlier owners are abandoning. In addition, employees often have no capital of their own to risk. Therefore, the federal government should loan funds or guarantee loans to ESOTs to enable employees to keep their plants open.[76] Of course, these funds or guarantees should only be provided to ESOTs which cannot secure private sector financing.[77] Furthermore, government funding or guarantees should only be available to ESOTs in plants that can be expected to survive the rigors of competition and sustain a profit.[78]

By preserving jobs such a program could significantly reduce the burdens placed on local economies by the closing of economically viable plants. If the guidelines for eligibility for government aid are carefully developed, the program could certainly be financially sound. Furthermore, such a program could lead to continued growth in this country's productive capacity and perhaps even reduce the overall unemployment rate of the country. Finally, such a program could contribute to greater worker satisfaction and productivity in those plants which become wholly employee-owned.[79]

IV. CONCLUSION

Employee stock ownership plans which guarantee employees full voting control over all employer securities held by the ESOT can yield valuable benefits. If the ESOT holds a great enough percentage of the corporation's securities, the employees will be assured of substantial participation in corporate affairs and a large share of corporate earnings. These advantages can make up for the greater risks inherent in the

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the corporation out of their post–tax savings. Hence, employees can use an ESOP to defer taxation and thus effectively reduce cost of employer securities.

[75] For example, the employees who purchased the South Bend Lathe Co. and the Vermont Asbestos Group were unable to secure private financing without governmental guarantees. *See* note 66 *supra*.

[76] The United States Economic Development Administration (EDA) has already assisted the employees of one company, the South Bend Lathe Co., keep a plant open. The EDA provided the city of South Bend with five million dollars to be loaned to the South Bend Lathe Co. ESOT, thereby enabling the employees to purchase their plant and keep it in operation. M. CONTE & A. TANNENBAUM, *supra* note 43, at 39. A much larger program should be established to make loans directly to ESOTs. In order to reduce the outlay of public funds, such a program could even integrate the administration costs into the loan charges repayable by the ESOTs.

[77] This condition could be satisfied by requiring that each applicant make a bona fide attempt to secure private financing and by requiring applicants to present letters refusing loans from one or more local lending institutions.

[78] Applications for assistance could be required to include supporting information in sufficient detail to enable the government to analyze the technical and economic feasibility of the proposal. In some cases the government may require a technical and economic feasibility study prepared by an independent consultant.

[79] *See* notes 43, 45 & 46 *supra*.

undiversified investments of ESOTs. Clearly, however, the Federal government should modify the present ESOP laws to ensure that only ESOPs which transfer a substantial percentage of voting corporate securities to the ESOT and which pass through full voting rights to employees will be entitled to preferential tax treatment.

ESOPs can also serve the important function of enabling employees to purchase their corporations. ESOPs can be used to prevent the closing of economically viable plants and to preserve jobs. In order to facilitate this use of ESOPs, the Federal government should develop a major program to provide financial assistance to employees who wish to keep their plants operating through ESOP employee buyouts. Such a program could help reduce unemployment and promote local economic stability.

—Jonathan Barry Forman