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Proposal for a Non-Subsidized, Non-Retirement-Plan, Employee-Owned Investment Vehicle to Replace the ESOP

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Proposal for a Non-Subsidized, Non-Retirement-Plan, Employee-Owned Investment Vehicle to Replace the ESOP

SEAN ANDERSON*
ANDREW MORRISON STUMPFF**

Abstract

Numerous observers, including both authors, have raised questions about employee stock ownership plans (ESOPs), which are a specialized category of retirement plan intended to invest primarily in securities issued by the sponsoring employer. Such arrangements are actively encouraged under federal law, as qualified retirement plans under section 401(a) and as eligible for significant additional, ESOP-specific tax subsidies. By design, ESOPs result in employees becoming effectively the owners of their own employer, via beneficial ownership of stock held by the plan. Although this idea can sound attractive, many have expressed concern from the standpoint of retirement policy: ESOPs have the effect of concentrating employees' retirement assets in a single stock—which would be troubling enough if the concentration were in any stock, but is much more so given that, in an ESOP, the concentrated investment is in employer stock. Risk of catastrophic loss of retirement security is thus simultaneously aggravated through lack of investment diversification and directly correlated with risk of job loss.

In this Article, however, the authors suggest that while ESOPs as currently constituted and subsidized are difficult to defend, nonetheless in some circumstances persuasive policy arguments exist for continuing to permit—and in special cases even encouraging—collective employee ownership of employer securities. Such arrangements should simply not be structured or regulated under the *retirement* system. For example, sometimes the proprietor of a business wishes to retire or otherwise liquidate his or her holdings, but no viable buyer can be found. In that situation—a not-uncommon context for creation of ESOPs, currently—it can often be argued that the best, most efficient available result may be for the company's employees to join together, secure financing on some collective basis, and purchase and continue to operate the business themselves.

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Under state and federal securities laws, however, it is currently far from clear whether such an arrangement could feasibly be established *except* by using an ESOP: that is, by using a retirement plan. We accordingly propose that the current retirement-based, tax-subsidized ESOP model of employer stock ownership be replaced by a new type of arrangement that would be treated and regulated as an investment vehicle by the Securities and Exchange Commission, much like a mutual fund, rather than by the Department of Labor and the Service under the U.S. retirement-plan system. Employee protections would be borrowed from the existing ESOP regime. Current retirement-plan tax subsidies would be eliminated, but the specific tax-deferral subsidy now available under section 1042 for security sales to employer-stock plans would be continued and even enhanced, albeit better targeted to arrangements for which the public subsidy makes sense.

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I. Introduction

Federal law both authorizes and subsidizes employee stock ownership plans (ESOPs)—retirement plans that invest primarily in the stock of the sponsoring employers. Elsewhere, we (and others) have explained why it is bad policy to treat ESOPs as retirement plans and to encourage them with subsidies.[1]

Here, we suggest that in certain circumstances, it makes sense for the law to authorize an investment vehicle that allows a company's employees to buy the company's stock. The emblematic case where such a vehicle makes sense is one in which a small or mid-sized company's founding shareholder seeks to retire, and no buyer appears who is willing to operate the company as a going concern. In such a scenario, employee ownership might be preferable to the company's demise. Yet it is at least unclear under existing law whether a non-ESOP employee-ownership vehicle would be viable.

Even in those circumstances, the employee-investment vehicle (which we dub a "TEST," for "taxable employee stock trust") should not be treated as a retirement plan. Instead, it should be regulated under federal securities laws. Furthermore, with limited exceptions, TESTs should not be subsidized.

II. ESOP Background and Criticisms

An ESOP is a retirement plan designed to invest its assets primarily in stock of the sponsoring employer.[2] Current federal law allows ESOPs to exist as qualified pension plans[3] by means of exceptions from rules that would otherwise outlaw them, and it encourages employers to adopt and maintain ESOPs by offering tax subsidies. As both of us have written before, that combination

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[1] Sean M. Anderson, *Risky Retirement Business: How ESOPs Harm the Workers They Are Supposed to Help*, 41 Loy. U. Chi. L.J. 1 (2009) [hereinafter Anderson, *Risky Retirement Business*]; Andrew Stumpff & Norman Stein, *Repeal Tax Incentives for ESOPs*, 125 Tax Notes (TA) 337 (Oct. 19, 2009) [hereinafter Stumpff & Stein, *Repeal Tax Incentives*]. Many others have made similar arguments. *See, e.g.*, William K. Bortz, *The Problem With ESOPs*, 147 Tax Notes (TA) 327 (Apr. 20, 2015); John H. Langbein, *Testimony to Senate Committee on Governmental Affairs* (Jan. 24, 2002), *reprinted as What's Wrong with Employer Stock Pension Plans*, *in* Enron and other Corporate Fiascos: The Corporate Scandal Reader 487 (Nancy B. Rapoport & Bala G. Dharan eds., 2d ed. 2009); David Millon, *Enron and the Dark Side of Worker Ownership*, 1 Seattle J. Soc. Just. 113 (2002); Henry Hansmann, *When Does Worker Ownership Work?*, 99 Yale L.J. 1749, 1811–12 (1990); William R. Levin, *The False Promise of Worker Capitalism: Congress and the Leveraged Employee Stock Ownership Plan*, 95 Yale L.J. 148, 165–70 (1985). That we have ESOPs at all is the historical result of lobbying by an idiosyncratic economist, Louis Kelso, during the 1960s and 1970s. *See* Andrew Stumpff, *Fifty Years of Utopia: A Half-Century after Louis Kelso's The Capitalist Manifesto, a Look Back at the Weird History of the ESOP*, 62 Tax Law. 419 (2009) [hereinafter Stumpff, *Fifty Years*].

[2] *See* I.R.C. § 4975(e)(7).

[3] A qualified pension plan is one that complies with the voluminous and complicated requirements of section 401(a), thereby qualifying for favorable tax treatment. *See infra* note 11 and accompanying text. References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (Code), unless otherwise indicated.

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of exceptions and incentives is bad retirement policy.[4] In this Part, we briefly describe the main ESOP-favoring provisions of federal law, recap the main objections to treating ESOPs as retirement plans, and criticize the notion that employee ownership ought to be subsidized.

A. *Federal Laws Allowing and Subsidizing ESOPs*

Without special exceptions, ESOPs would violate several rules applicable generally to pension plans under ERISA and the Code. First, ESOPs and most other defined contribution pension plans are exempt from a rule that bars plans from holding more than ten percent of their assets in the form of employer stock.[5]

Second, most purchases and sales of employer stock by an ESOP would be "prohibited transactions"[6] were it not for a statutory exception allowing ESOPs and other "eligible individual account plans" to transact in "qualifying employer securities."[7]

Third, the arrangements whereby "leveraged" ESOPs borrow money to finance the purchase of employer stock would, ordinarily, be prohibited transactions themselves. In leveraged ESOP transactions, the sponsoring employer commonly either lends the ESOP money or guarantees a loan to the ESOP by a commercial lender. Only an ESOP-specific exception saves those loans and guarantees from being prohibited transactions.[8]

Finally, ERISA ordinarily requires the "fiduciaries" who administer pension plans to diversify investments "unless under the circumstances it is clearly prudent not to do so."[9] Because ESOPs, by definition, invest primarily or exclusively in the stock of a single company, ESOP fiduciaries routinely violate the diversification norm. ERISA, however, provides an exception allowing eligible individual account plans, including ESOPs, to acquire and hold employer stock unfettered by the duty of diversification.[10]

Besides excepting ESOPs from rules that they would otherwise violate, federal law provides an incentive for ESOPs. First, ESOPs share with other qualified plans the advantage of decoupling the tax consequences of plan

[4] *See* Anderson, *Risky Retirement Business*, *supra* note 1, at 6–23; Stumpff & Stein, *Repeal Tax Incentives, supra* note 1, at 338–40.

[5] ERISA § 407(a)(2), 29 U.S.C. § 1107(a)(2).

[6] Both ERISA and the Code include prohibited transaction provisions. I.R.C. § 4975; ERISA §§ 406, 408, 29 U.S.C. §§ 1106, 1108. Because the Code provisions apply specifically to qualified pension plans, including ESOPs, we will refer to the Code provisions, although any differences between the Code and ERISA in this regard are unlikely to matter.

[7] I.R.C. § 4975(d)(13) (citing ERISA § 408(e), 29 U.S.C. § 1108(e)).

[8] *See* I.R.C. § 4975(e)(2)(C) (including sponsoring employer as disqualified person); (c)(1)(B) (listing as a prohibited transaction any "lending of money or other extension of credit between a plan and a disqualified person"); (d)(3) (excepting from prohibited transaction prohibitions, under specified circumstances, "any loan to a leveraged employee stock ownership plan").

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

[10] ERISA § 404(a)(2), 29 U.S.C. § 1104(a)(2).

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contributions for the employer and the employee. The employer may deduct contributions when it makes them, but each employee-participant can wait to include the contributions as income until he or she withdraws them from the plan, years or decades later.[11]

ESOPs also receive additional tax incentives. Often, a person selling employer stock to an ESOP can indefinitely defer recognizing and paying taxes on the gain from the sale.[12] The sponsoring employer may deduct from its taxable income dividends paid on ESOP stock, and distribution of those dividends is exempt from a ten percent tax usually applied to premature distributions from qualified plans.[13] Shares of employer stock distributed from a qualified plan, including an ESOP, also receive favorable tax treatment with respect to net unrealized appreciation, allowing, in some circumstances, for a permanent exclusion from income.[14]

Notably, nowhere in the tax or ERISA rules governing ESOPs will one find any requirement that employees have any choice as to whether to participate. A company's management may implement an ESOP with or without its workers' approval, and employees need not (and ordinarily do not) have any ability to opt out of the ESOP and receive, instead, either extra compensation or contributions to some other retirement plan.

B. *Objections to ESOPs as Subsidized Retirement Plans*

1. *ESOPs Are Indefensible as Retirement Vehicles*

The fact that federal law treats ESOPs as retirement plans results from historical accident rather than thoughtful design.[15] As it turns out, ESOPs are singularly inappropriate as retirement plans—that is, as instruments for focusing tax incentives for the purpose of helping individuals finance their retirement years. What follows is a brief summary of the chief reasons for that conclusion, which we have elaborated more fully elsewhere.[16]

The central reason why ESOPs represent bad retirement policy is that they are inherently undiversified. More than a half-century of theoretical and empirical scholarship has elaborated on the principle that a diversified portfolio of investments is preferable, ex ante, to a concentrated investment in a single security. The reason, albeit complicated in its details and permutations, is simple in its essence: An investment in a single security, such as stock in one company, carries with it all the risks associated with that company,

[11] *See* I.R.C. §§ 404 (governing deduction for employer's contributions); 402 (governing taxability of distributions).

[12] *See* I.R.C. § 1042.

[13] I.R.C. §§ 404(k), 72(t)(2)(A)(vi).

[14] *See* I.R.C. § 402(e)(4); Stumpff & Stein, *Repeal Tax Incentives*, *supra* note 1, at 338.

[15] For a recounting of the development of these arrangements, *see* Stumpff, *Fifty Years*, *supra* note 1.

[16] Anderson, *Risky Retirement Business*, *supra* note 1, at 6–13; Stumpff & Stein, *Repeal Tax Incentives*, *supra* note 1, at 338–40.

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the industry in which it operates, its geographic location, and the like. That single-security investment also carries with it risks specific to its asset class-equity investment. A portfolio of investments, on the other hand, can include multiple classes of investments, including securities of multiple companies, in multiple industries and locations, whose risks can to a significant degree offset one another.

An ESOP concentrates a great deal of each participant's retirement savings in employer stock, creating an undiversified position. If the employer goes out of business, or its stock otherwise "tanks," the value of ESOP participants' retirement savings will plummet. Even barring such catastrophes, the undiversified character of the ESOP investment will, on average, result in ESOP participants having less to live on in retirement than if the employer had contributed instead to a pension plan with properly diversified investments.[17]

Moreover, an ESOP's lack of diversification serves to compound employees' inherently undiversified investment of "human capital."[18] If the employer goes out of business, or reduces its workforce due to dire financial difficulties, some or all of its employees will lose their jobs and non-retirement benefits, such as subsidized medical insurance. If their retirement savings are in an ESOP, they stand to lose some or all of their retirement savings in the same stroke.

Defenders frequently point to examples where ESOP companies have done well.[19] But, of course, against these anecdotal examples can be assembled quite a few countervailing ones involving ESOPs that have lost much, and in some cases effectively all, of their value.[20] Anecdotal evidence is unilluminating. That some individuals have won the lottery does not prove that concentrated investment in lottery tickets is a good investment approach. Statistically, it is a fact that many companies will fail and some will succeed; sound public retirement policy favors a system under which workers, while they may not have a high prospect of astronomic gain, also do not face significant risk of catastrophic loss, over a system in which there are many big winners and many big losers. Even if it could be shown that the *average* ESOP company does better economically than the average non-ESOP company, that would not lessen the need for diversification. *Some* ESOP companies will fail, and their employees' retirements should be protected against this risk.

In this regard, we note that a company's workers, even collectively, may have little or no control over whether the lottery ticket they happen to hold turns out to be a winner: They may, for example, simply be in the wrong

[17] *See* Lisa Meulbroek, *Company Stock in Pension Plans: How Costly is It?*, 48 J. L. & ECON. 443, 455–65 (2005) (Table IV); Anderson, *Risky Retirement Business*, *supra* note 1, at 8–10.

[18] *See* Stumpff & Stein, *Repeal Tax Incentives*, *supra* note 1, at 339.

[19] *See, e.g.*, JOSEPH R. BLASI, RICHARD B. FREEMAN & DOUGLAS L. CRUSE, THE CITIZEN'S SHARE: PUTTING OWNERSHIP BACK INTO DEMOCRACY 75–81 (2013).

[20] ESOP sponsors have included the bankrupt companies Enron Corporation, Bear Stearns, Lehman, United Air Lines, WorldCom, and Chicago Tribune, among others. For further examples, see Anderson, *Risky Retirement Business*, *supra* note 1, at 6–7.

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industry at the wrong time, as in the case of the failed Chicago Tribune ESOP (among many others). There simply remains no reasonable doubt that diversification is the better investment practice.[21]

In addition to under-diversification, ESOPs also carry with them conflicts of interest between company "insiders" and rank-and-file participants that are more severe than those associated with other pension plans.[22] Primarily because ESOPs can borrow money, ESOPs can be used as tools of corporate finance and succession planning. Such purposes are, to say the least, not coextensive with the purposes that, by law, must motivate those who administer pension plans—maximizing retirement benefits and defraying reasonable costs.[23]

2. *ESOPs as "Extra" Compensation*

As we have noted, the principal argument against ESOPs—that they entail unjustified, undiversified investment risk for employees—has been made on many previous occasions.[24] We think, however, that special mention should be made here of a frequent response to this contention, to the effect that our concern about risk to employees is misplaced because ESOPs are *additive* and do not reduce the other compensation received by employees.[25] As a result, this response goes, ESOP investment risk is irrelevant: Any gains accruing to employees through the ESOP are extra to other compensation, and so even if the ESOP turns out ultimately to be of little or no value, participants will have been made no worse off than had the ESOP not been adopted. Under this argument, ESOP participants can win but can never lose.

It cannot, however, be generally true that establishing an ESOP involves paying compensation that is an extra amount over the pay employees would otherwise receive. As a matter of logic and evidence, stock (or any in-kind) compensation serves as a substitute for cash: The worker receives a smaller paycheck and a forced, risky investment in her employer.

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[21] *See* HARRY MARKOWITZ, PORTFOLIO SELECTION: EFFICIENT DIVERSIFICATION OF INVESTMENT (2d ed. 1991); Paul A. Samuelson, *General Proof that Diversification Pays*, 2 J. FIN. & QUANTITATIVE ANAL. 1 (1967), among many others.

[22] *See* Anderson, *Risky Retirement Business, supra* note 1, at 13–23.

[23] *See* ERISA § 404(a)(1)(A), 29 U.S.C. § 1104(a)(1)(A) (requiring plan fiduciaries to discharge duties to the plan "for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan . . .").

[24] *See* sources cited *supra* note 1.

[25] *See* Corey Rosen, *Do ESOPs Need Reform? A Look at what the Data Tell Us*, 147 TAX NOTES (TA) 1465, 1466 (June 22, 2015); Robert Buchele, Douglas L. Kruse, Loren Rodgers & Adria Scharf, *Show me the Money: Does Shared Capitalism Share the Wealth?*, *in* SHARED CAPITALISM AT WORK: EMPLOYEE OWNERSHIP, PROFIT AND GAIN SHARING, AND BROAD-BASED STOCK OPTIONS 362–65 (Douglas L. Kruse, Richard B. Freeman & Joseph R. Blasi eds., 2010). Usually the evidence offered is simply that a company also provides some other retirement plan or that overall compensation at the company seems high. The intrinsic logical issues discussed below do not seem to have been addressed, and the proffered evidence is furthermore inherently subject to the "survivors' bias" problem: It fails to take into account companies that have, for example due to bankruptcy, ceased to exist.

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For the ESOP proponents' arguments to be tenable, not only must the ESOP not be paid for from the workers' current paychecks, but also the ESOP must not be paid from the paychecks or retirement benefits the workers would have received in the future, had the ESOP not existed. It is difficult to see how this could possibly, even in theory, remain true over the long run. The labor market can be presumed to set a competitive wage and benefit level for a given job, and for ESOP companies to be routinely paying in excess of that market level (by providing the compensation package they would have anyway, plus the ESOP) would be per se unstable: All workers, for example, should be expected to be flocking to ESOP companies, all the time. Moreover, such above-market compensation would have to come from somewhere, meaning ESOP companies would have to reduce other outlays or continuously generate "extra" revenue over and above what was projected in valuing the ESOP's stock or both.[26] In fact we believe most or all ESOP sponsors themselves regard ESOP contributions as, at least in part, a component of the employees' compensation, which is certainly how the plans are marketed to employers and employees alike.

Only rarely, of course, is it possible to unravel empirically the basis on which an ESOP has been established, and whether, in particular, it has been adopted in lieu of other compensation. But at least one such instructive context does exist: that of union-negotiated compensation packages. Many publicly documented cases exist of union–management negotiations resulting in the creation of an ESOP, and these confirm that, as logic would suggest, the plans were included in the ultimately agreed compensation package as a negotiated, specific substitute for cash compensation that the union had sought.[27]

In any case, it is enough to observe that the Code imposes no requirement that, as a condition to availing itself of those ESOP-related tax subsidies, a company somehow show that its ESOP is additive to the pay and benefit package the company would have provided anyway. And if ESOP benefits are provided, even partially, instead of salary or retirement benefits otherwise payable by the company, then the nondiversification objection seems insurmountable. In that case ESOPs will simply have had the effect of forcing a risky concentration of employees' investments.

3. *Public Economic Incentives for Employee Ownership Are Indefensible*

Beyond whether the law should treat ESOPs as *retirement* vehicles, a larger question is whether they or similar employee stock arrangements should be

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[26] For elaboration of this point, see Andrew Stumpff, *Perpetual Motion Machines: ESOPs Do Not Pay For Themselves*, 159 Tax Notes (TA) 1289 (May 28, 2018).

[27] *See, e.g.*, Charles Storch, *UAL Deal a Hard Sell to Workers*, Chi. Trib. (Oct. 10, 1989), Sec. 3, p. 1; David Hench, *Portland Newspaper Guild to Vote on Concessions for Blethen Sale*, Portland Press Herald (May 26, 2009), http://www.reclaimthemedia.org/corporate_power/consolidation/portland_newspaper_guild_vote_2622.html; *see also* Robert J. Flanagan, *Wage Concessions and Long-Term Union Wage Flexibility*, *in* 1 Brookings Paper on Economic Activity 183, 207–08 (1984).

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publicly subsidized, in any form, through the tax law. ESOP advocates insist that employee ownership, properly implemented, bestows competitive advantages, most notably by enhancing employees' productivity.[28] We are deeply skeptical of that claim, for reasons one of us has described before.[29] If the claim is false, then in light of the objections summarized in Part II.B.1 above, any general policy of subsidizing employee ownership seems at best perverse.

But the ultimately compelling point about incentives may be that, even if (especially if) the claim of increased productivity were *true*, it could not justify subsidies, whether in the form of tax advantages or otherwise. If ESOPs convey a competitive advantage, one would suppose rational business managers would hasten to adopt them in the absence of any subsidy. Indeed, under the assumption that, over the long run, markets behave appropriately Darwinistically, the fact that ESOPs have not by now been universally (or even particularly commonly) adopted by American companies—despite decades not merely of availability but of active government subsidy—ought to be taken as compelling evidence that such arrangements do not confer the claimed competitive economic advantage.

C. *Summary*

For the reasons suggested above, Congress should repeal the exceptions in the Code and ERISA that allow ESOPs to exist as qualified pension plans. Furthermore, Congress should do away with the current favorable tax treatment of employee-ownership arrangements.

III. A Possibly Justified Exception: The Departing Founder Scenario

Part II summarized our related contentions that collective ownership by employees of their employers should be neither (1) part of the retirement system nor (2) tax-subsidized. The question remains, however, whether collective employee ownership ought to be legally *permitted*, even if not subsidized, and even if not as an element of retirement policy. As we describe in Part IV, it is at least doubtful whether it would at present be legally permissible or feasible to construct collective employee ownership in any way *other* than through the tax-subsidized "retirement plan" ESOP model. Perhaps it should be, at least under certain circumstances.

Imagine for example a small company, located in a small town, in a remote area with few other locally situated employers. The founder wishes to retire or has died. This seems a fairly common scenario.[30] Everyone involved would prefer the company to continue in operation, but the owner or estate does not wish to sell to an outside buyer, or none has materialized.

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[28] *See* sources cited at Anderson, *Risky Retirement Business*, *supra* note 1, at 25–26 nn. 107–18.
[29] *Id*. at 26–28, and sources cited therein.
[30] This was originally the prototypical ESOP situation, as described in Stumpff, *Fifty Years*, *supra* note 1, at 422.

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Such situations can transform a personal life-transition for a company's owner into a potentially calamitous, and possibly avoidable, economic event for not only the directly affected workers but also the entire community. In these cases, an impediment appears to exist to what might be the most efficient and socially productive outcome—an impediment that prevents an outside owner from materializing to continue an economically profitable activity in the same location. The impediment may in many cases simply be the physical site of company facilities. In others it may be that the company is too small or occupies too narrow an economic niche to interest a buyer for practical reasons. In such a case inefficiency in the market will arguably have arisen, simply because there is no available and willing new potential owner with the requisite expertise and experience to continue the company in operation in its present form and location. Further, the absence of such an owner arguably reduces, not merely local economic well-being, but overall economic efficiency.

For convenience we will refer henceforth to this general class of situations as the "departing founder scenario"—although much the same set of circumstances can arise generations after the original founder is gone, but while the company is still closely held in local hands.

In the departing founder scenario, perhaps there ought to be a way, with appropriate safeguards, for the company's employees to form a collective finance vehicle to purchase all the shares and continue operating the company themselves. That might be the best result from every point of view: The employees are already on-site, and they have knowledge and expertise about the company's operations. Their collective assumption of ownership could allow perpetuation of an economically viable enterprise, avoid loss of jobs, and perhaps help preserve the economic vitality of the region.

One point to note is that the rationale for permitting collective ownership in this case does not depend upon the notion that employee ownership is generally a good idea—a proposition that, as discussed in Part II, is questionable. A second point is that, other than in the departing founder scenario, it remains difficult to argue that any departure from prevailing regulation should apply. In other situations, it is hard to see why investment in one's employer is different, and thus justifies different regulation, from any other investment. The question seems particularly difficult to answer, for example, if the company is public—meaning that in some sense outside ownership is *always* available.

Even in the central, departing-founder-of-a-nonpublic-company scenario, an investment vehicle permitting employees collectively to take ownership of the employer should not generally be *tax-subsidized* or provided through the *retirement system*, as ESOPs are. The suggestion is only that such a vehicle should be permitted. As described in the next Part, however, under current law a tax-subsidized ESOP is not only currently *an* available option: It is likely *the only* legally viable, or at least clearly viable, alternative.

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IV. Securities Law Obstacles to Non-ESOP Employee Ownership

Under current securities law, a collective finance vehicle for employee ownership that is not an ESOP may be impermissible, or may at least be subject to effectively disabling regulation. Exceptions might apply to some aspects of such a vehicle's operation, but that application is uncertain. And that very uncertainty would itself make using the non-ESOP vehicle less desirable. Potential problems arise with respect to both federal and state securities laws.

A. *Federal Law*

At the risk of oversimplifying, the Securities Act of 1933 (the '33 Act) requires the registration of certain securities transactions, and the Securities Exchange Act of 1934 (the '34 Act) requires the registration of certain classes of securities.[31] ESOPs are a species of "qualified" retirement plan,[32] and as such are in many respects excused from those registration requirements.[33] A collective finance vehicle that was not a qualified plan would lose those protections.

Similarly, the Investment Company Act of 1940 (the '40 Act) requires registration of investment companies and imposes substantial regulation but excludes qualified plans from the definition of an investment company.[34] Again, a non-ESOP investment vehicle could not avail itself of that exception.

Potentially, then, a non-ESOP vehicle designed to permit employees to buy their employers' shares might be subject to registration and other regulation under the '33, '34, or '40 Acts. In many instances, the vehicle might arguably be exempt under one or another Act for other reasons, but significant uncertainty would remain, particularly in larger companies. For example, under the '34 Act, the investment vehicle would in many instances be exempt from registration because its securities would not be traded on an exchange, it would not have over $10 million in assets, and it would not have more than 500 shareholders who are not "accredited investors" as defined under the statute.[35] Similarly, some such vehicles, at least initially, would have fewer than 100 beneficial owners and, therefore, would not be investment companies for most purposes under the '40 Act.[36]

Particularly over time, however, some collective finance vehicles would likely exceed these numerical limits. Other potential exemptions from portions of

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[31] *See* Kirk F. Maldonado & Susan J. Daley, *Securities Law Aspects of Employee Benefit Plans*, 362-4th Tax Mgmt. Port. (BNA) Part II(C) and (D) (2008).

[32] *See generally* I.R.C. § 401(a) (controlling requirements for plan qualification).

[33] *See generally* Malonado & Daley, *supra* note 31, at Part II(D). One specific exemption, for instance, is 15 U.S.C. § 77c(a)(2), which exempts from registration under the '33 Act certain participation interests "issued in connection with . . . a stock bonus, pension, or profit-sharing plan which meets the requirements for qualification under [section 401(a)]."

[34] 15 U.S.C. § 80a-3(c)(11).

[35] *See* 15 U.S.C. § 77b(a)(15).

[36] *See* 15 U.S.C. § 80a-3(c)(1) (exempting, for most purposes, "[a]ny issuer whose outstanding securities . . . are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities").

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the securities laws might exist, but their application would be uncertain, and in any event might reach only some, but not all, collective finance vehicles.[37]

If a nonretirement-plan alternative for employee ownership is to have a chance to succeed, it would need clear authorization under federal securities law, as well as an accompanying exemption from state laws regulating securities.

B. *State "Blue Sky" Laws*

Individual states have adopted so-called "blue sky" laws designed to combat fraud. Although these laws vary, they commonly require registration of securities transactions. Under current law, because ESOPs are treated as employee benefit plans, they benefit from ERISA's sweeping preemption of state and local laws. Although ERISA's preemption provision excludes state laws that regulate securities, it also forbids states from treating employee benefit plans as if they were investment companies.[38] In addition, many state codes include express exemptions for transactions involving employee benefit plans.[39]

An employee ownership vehicle that was not an employee benefit plan would lose the benefit of ERISA preemption. In some states, it might be exempt from some or all "blue sky" requirements, but the organizers of the vehicle would have to investigate that possibility in every potentially relevant state, and then regularly monitor those states' laws for any important changes. Even assuming that exemptions might apply, the resulting uncertainty and expense would itself reduce the incentive to form non-ESOP employee ownership vehicles.

V. A Proposal

As we have shown in Part II, the existing ESOP legal regime is not justifiable and seems a good candidate, as a matter of policy, for elimination. As described in Part III, however, there seems to be a reasonable policy argument, in certain limited contexts like the retiring founder scenario, for permitting collective employee ownership. As just demonstrated in Part IV, simply eliminating ESOPs would leave, apparently, no clear legal option available to achieve that result.

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[37] Under the '40 Act, for example, see 15 U.S.C. §§ 80a-3(c)(12) (excluding from the definition of an investment company "[a]ny voting trust the assets of which consist exclusively of securities of a single issuer which is not an investment company"); 80a-3(b)(1) (excluding an entity that is "primarily engaged . . . , through a wholly-owned subsidiary . . . , in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities"); 80a-6(b) (excluding "employees' security companies"). The '34 Act exempts from registration securities issued by certain cooperatives, but the exemption is limited to farming cooperatives and others in which the commodity or service supplied is primarily for the benefit of members. 15 U.S.C. § 78*l*(g)(2)(E)–(F). That limitation and others would make the cooperative form impractical in most departing-founder situations.

[38] The sweeping preemption provision is ERISA § 514(a), 29 U.S.C. § 1144(a). The exception for securities laws and the prohibition on "deeming" a plan or its trust to be an investment company are in ERISA § 514(b)(2), 29 U.S.C. § 1144(b)(2).

[39] *See, e.g.*, MCLA § 451.2202(u) (Michigan).

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In light of the above, we propose that Congress consider overhauling federal securities laws to permit collective employee ownership through a trust in certain circumstances, while removing from the tax law and ERISA the existing ESOP subsidies and exemptions. We call such a trust a "TEST," standing for "taxable employee stock trust."

Our proposal is limited to the departing founder scenario; it does not extend to scenarios—involving public companies, for example—where the circumstances that recommend permitting a collective ownership structure are not present. Moreover, in part for simplicity and because the existing economic model is now well understood, we believe the proposed vehicle should generally function like an ESOP (and permit comparable borrowing to finance stock purchases) without most of the tax subsidies and without "retirement plan" characterization, treatment, or regulation. In brief, we suggest that a system be created that would allow nonsubsidized employee ownership, provided employees do in fact have meaningful ownership and provided many of the same statutory protections in place under the current ESOP system remain.

Implementing this proposal would involve amending federal securities and tax law, as well as ERISA. The principal revisions required under our suggested approach are as follows.

A. *Securities Law*

As discussed in Part IV, it may be legally permissible even under current securities laws to create and operate a collectively owned employee ownership structure. That point is not clear, however, and so a major emphasis of our proposal would be to remove doubt about this securities-regulation conclusion.

Accordingly, explicit exemptions would be provided under the Securities and Exchange Acts for entities that meet the requirements listed below. The new form of entity would be regulated by the Securities and Exchange Commission (SEC), rather than by the Department of Labor, under a model more like that applicable to mutual funds under the '40 Act. We make this suggestion, again, because employee collective ownership vehicles are not properly considered "retirement" vehicles and, therefore, do not really fall within the expertise of the Department of Labor. They are, rather, investment vehicles much more akin to the types of arrangements typically overseen by the SEC. Furthermore, without any tax subsidy, there would be no reason to involve the Service.[40]

[40] We recognize there may be policy reasons in some cases for providing for "enforcement diversity." *See* Dana Muir, *Decentralized Enforcement to Combat Financial Wrongdoing in Pensions: What Types of Watchdogs Are Necessary to Keep the Foxes Out of the Henhouse?*, 53 Am. Bus. L. J. 33 (2016). However, we think such goals could be better achieved, in the case of a TEST, by supplementing SEC oversight with a private right of action for participants, rather than by involving the Service in an essentially investment-regulatory context in which that agency has limited expertise.

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Moreover, the SEC requirements and oversight to which TESTs would be subjected could safely be limited, in our view. Many of the substantive issues traditionally the subject of securities law—aggressive sales practices; incomplete financial disclosure to potential purchasers—do not fully apply to nonvoluntary transfer arrangements such as a TEST (or an ESOP). These arrangements do not involve, at least directly, a "purchase decision" in the same way as does an offer to sell stock or mutual fund shares to an investor.

Of course, in an abstract sense an employee could be thought of as purchasing TEST or ESOP interests in exchange for agreeing to provide his or her labor. That is not, however, an argument the courts or the SEC have ever found persuasive in the case of "nonvoluntary," nonelective employee arrangements.[41] And, indeed, in practical terms it does seem a stretch to treat as subject to full securities-based oversight situations where an interest in employer stock is simply provided as part of an employee's compensation package without regard to his or her preference or choice. This is effectively just one case of in-kind labor compensation (one could also imagine, for example, compensating employees in the form of gold bullion, or kitchen appliances, or food) and is, we think, best left to the direct regulation of labor compensation through, for example, minimum wage and state wage-and-hour laws as well as the functional market for personal services, which should only rarely leave an employer with any practical alternative but to pay the bulk of compensation in the form of cash wages. An individual's decision to work or not to work for a particular employer under such circumstances—which would serve as the sole conceptual basis for regarding the transaction as a "securities purchase"—is likely to be in practice only tangentially driven, at most, by the individual's evaluation of the company's stock investment prospects.[42]

Certainly, basic antifraud securities rules should apply. Employers should not be permitted to entice prospective employees (or to retain existing ones) by lying about their prospects for enrichment through TEST interests. Extensive and formalized disclosure, however, of the type required of mutual funds (under the '40 Act) and individual company stock offered for sale to the public (under the '33 Act) seems unjustified. Among other things, the current-law ESOP protections that we envision continuing to apply to TESTs, as described below, would effectively address most of the concerns to which, in the case of stock sales, securities disclosure rules are directed.

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[41] Int'l Bd. of Teamsters v. Daniel, 439 U.S. 551 (1979); Exchange Act Release No. 33-6188, 45 Fed. Reg. 8,960 (Feb. 11, 1980); Exchange Act Release No. 33-6281, 46 Fed. Reg. 8,446 (Jan. 27, 1981). For a good discussion of the (often somewhat incoherent) historical judicial treatment of this issue, see Robert Anderson IV, *Employee Incentives and the Federal Securities Laws*, 57 U. Miami L. Rev. 1195 (2003).

[42] If this empirical prediction were proved wrong, and rank-and-file employees were shown to be making employment decisions based, for example, on questionable or aggressive touting of stock prospects, then our recommendations would be subject to reconsideration.

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The securities law exceptions would also, under our proposal, preempt state securities ("blue sky") regulation, in order to replicate the preemptive securities-regulation benefit now enjoyed by ESOPs.

B. *Tax Law*

With certain significant exceptions specifically targeted to the departing founder scenario, no tax subsidies would be extended to the new entity. This has the following implications.

1. *Taxation of the Trust*

The trust through which employees own stock would be taxable under the usual rules that apply to an ordinary nongrantor trust. This may not be particularly consequential, depending on demographics and cash-flow patterns. The income of such a trust is generally taxable, but the trust is at the same time entitled to deduct distributions made to beneficiaries.[43] The trust would be expected to realize taxable gains only upon liquidating employer stock—a relatively infrequent occurrence and one that would coincide with deductible distributions to participants.

2. *Taxation of Participants*

Employees would be taxed on their vested share of contributions to the trust under section 83 (in precisely the same way direct compensatory stock grants are taxed). That is, the fair market value of participants' vested interests in the trust would be taxable as ordinary income on the later of the date of grant or of vesting, and no further tax consequences would arise until the employees' interests were liquidated, at which time any gain or loss would be treated as capital in character.

Removing employer securities from the qualified plan taxation regime and, as described below, from the universe of permitted employee plan investments under ERISA would have collateral consequences. One consequence would be that current section 402(e)(4), which permits favorable capital-gain treatment of unrealized investment gains on employer securities distributed from an employee benefit plan, would no longer be required.

3. *Taxation of Transferor*

We suggest, however, that the deferral of a seller's gain upon sale of stock to the trust, which is currently provided for under section 1042, continue to be permitted under generally the same conditions as currently apply. These conditions include that the seller of the securities have held them at least three years before transfer to the TEST, and that the trust must hold at least 30% of

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[43] *See* Andrew W. Stumpff, *The Unimportance of Being a VEBA: Tax Attributes of Nonexempt Welfare Benefit Trusts*, 47 Tax Law. 113 (1995).

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the stock after the sale.[44] This would actually continue to *encourage* departing founders to sell going concerns to their workforce, rather than liquidate or otherwise "cash out" to the detriment of the employees and local stakeholders.

We would go even further, in fact, and suggest Congress consider creating a new tax subsidy, consisting of full or partial deduction of the fair market value of any stock donated (not sold) by the departing founder to a TEST. We would condition this deduction on the same conditions as are necessary for section 1042 treatment, as well as other requirements including that the transfer is a bona fide gift[45] and that the taxpayer is not related to employees owning 50% or more of the trust interests.

Both of these subsidies, in the departing founder scenario, seem consonant with the long-accepted idea of tax-subsidizing charitable activity—the "charity" in this case being the public benefit of preserving local jobs and the economic vitality of the company's geographical environs.

C. *ERISA*

The statutory retirement plan exemptions (from ERISA's diversification and prudence requirements) for employer stock investment would be eliminated. This change would effectively remove employee stock-ownership plans from the retirement system.

D. *Conditions*

The rationale that would extend liberalization of securities law specifically to employee ownership vehicles applies only under certain circumstances. Accordingly, restrictions (which would be spelled out in the text of the Securities and Exchange Acts) should apply to the availability of the exemption, as follows:

1. *Private Employers*

To be eligible, the employer-company could not be publicly traded immediately before creation of the TEST. In the publicly traded case, there would be no need for relaxing the securities laws, and no rationale would exist for facilitating collective employee ownership, since a functioning ownership market would already exist.

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[44] We do not suggest this requirement as a condition for permissibility of the vehicle but only as a condition for this particular tax benefit.

[45] This may, in turn, require as a conceptual matter that the departing founder give up (by the transfer itself, or in combination with a sale of other shares) any remaining ownership in the company. Regulations under section 83 currently treat (soundly, it would appear, as a matter of logic) a transfer of property from a corporation's continuing shareholder to its employee not as a gift but, instead, generally as a deemed contribution to corporate capital (increasing the shareholder's basis in retained shares), followed by a compensatory payment by the corporation to the employee. Reg. § 1.83-6(d)(1).

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2. *Employee Owners Only*

Acquisition of trust interests would be limited to employees of the issuer or their inheritors. Otherwise, again, the policy rationale underlying the securities-law exemption would not apply: The acquisition of an interest in the trust by someone other than an employee would have much more the character of an ordinary "investment" transaction, of the sort which existing securities laws are fundamentally intended to protect.

3. *Additional Retirement Benefits*

ESOP supporters routinely justify the investment concentration inherent in such arrangements by arguing that most employers also maintain, in addition to the ESOP, some other retirement plan with more defensibly diversified investments, such as a section 401(k) plan. We think it would be a good idea to call employee-ownership advocates on this claim—and, more to the point, to ensure that a TEST is not maintained as an economic substitute for meaningful, diversified workforce retirement savings. Accordingly, we suggest that as a condition to adoption of a TEST, an employer be required also to establish and maintain a conventional retirement plan, providing benefits at least as favorable as those required under a "safe-harbor" plan under section 401(k)(12).[46]

4. *Continued ESOP Protections*

Employees holding interests in a TEST would be at financial risk even under our proposal. Accordingly, we suggest that several of the substantive requirements currently applicable to ESOPs would continue to apply to these arrangements. The following are the principal existing requirements for ESOPs, with a brief discussion of whether each should continue in effect under our proposal, and why.

Security Class. To qualify currently as an ESOP, a plan must primarily invest in "qualifying employer securities," which are defined in section 409(l) and ERISA section 407(d)(5) to mean, in the case of a nonpublicly traded company, common stock having voting and dividend rights at least as favorable as any other class of the company's common stock. We suggest retaining this requirement, as a way of discouraging manipulation of the TEST rules to create nominally employee-owned vehicles that in reality function as mere financing schemes. We believe the argument for encouraging collective

[46] Section 401(k)(12) establishes two alternative design-based "safe harbors," which if adopted relieve the employer from having to test contributions for prohibited discrimination in favor of highly compensated employees under the usual "actual deferral percentage" or "actual contribution percentage" tests. The first safe harbor applies if the employer matches specified proportions of participants' elective contributions; the second, alternative safe harbor applies if the employer simply agrees to make nonelective contributions (in addition to the participants' elective contributions) of at least three percent of compensation.

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employee ownership is most plausible only when no other party can be found who is willing to purchase a controlling interest.

Valuation. Section 401(a)(28)(C) requires that nonpublicly traded stock held by an ESOP be valued by an "independent appraiser" meeting requirements set forth in Treasury regulations. We would continue this requirement in effect (and, because our proposal would apply only to nonpublic companies in the first place, the limitation to "nonpublic" under this rule would no longer be necessary).

Liquidity. Current ESOP law contains a number of protections aimed at the general problems of diversification and liquidity, given the concentrated financial risk inherent in the idea of an ESOP. Section 409(o), for example, sets forth a distribution requirement, pursuant to which a participant generally must be able to elect full distribution over no more than a five-year period commencing within a year after retirement, disability, or death; and commencing within five years of any other separation from service. We suggest that this requirement be retained for its protective effect and because the foundational idea is that current employees would be owners of the TEST—not that retired employees' wealth would continue indefinitely to be tied to their former employer.

Section 401(a)(28)(B) currently provides that ESOP participants who have attained age 55 with ten years of participation must be given, each year for six years, the right to elect to diversify a portion of their account balances (eventually up to 50% of the accounts' value) through either distribution or investment in other investment options. This requirement seems to depend for its policy rationale on the idea of an ESOP as a retirement plan; and we would not suggest continuing it.

To protect employees as investors, we would, however, leave in place the requirements of section 409(h). Under that provision, a participant must have the right to demand securities as a form of distribution. If the participant demands and receives such a distribution, the participant must have a "put" right, exercisable for 60 days after distribution, to compel the company to repurchase the shares so distributed for fair market value.

Governance Pass-Through (e.g., Share Voting Rights). Section 409(e) generally requires, with certain exceptions, that employees be provided the right to direct the voting of shares allocated to their accounts. We would continue this requirement to avoid TESTs being used simply as financing schemes.

All the above continuing safeguards would be moved from the Code, instead becoming conditions to the securities law exemptions described above. As noted above, we suggest that the SEC, not the Department of Labor or the Service, be placed in charge of interpreting and enforcing all these continuing requirements.

VI. Conclusion

ESOPs in their current form are indefensible as a matter of national retirement plan and tax policy. The major argument ESOP supporters have put

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forward for such arrangements is that employee ownership is a particularly successful way to organize economic entities. If that is the case, then government subsidies—let alone subsidies extended through the retirement system—are unnecessary and inappropriate: employee ownership vehicles need simply be *permitted*. Our proposal would accomplish this in a targeted way while removing ESOPs from the retirement system. The rationale for permitting employee ownership vehicles is particularly strong in the case of smaller companies when the founding or sole owner is withdrawing or has died, and our proposal would actually expand the incentives for employee ownership in that context. One advantage of the proposal is that it seems potentially (slightly) more politically viable than simple abolition of ESOPs with no replacement.

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