# THE ESOP AT THIRTY: A DEMOCRATIC PERSPECTIVE

MICHAEL E. MURPHY*

## I. INTRODUCTION

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

### A. *History of the ESOP*

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

---

* Judicial Attorney, California Court of Appeal, First District; Ph.D., University of California, Berkeley; J.D., Stanford University; B.A., Harvard University; Lecturer, Geography Department, University of Texas at Austin, 1986-1987; member California Bar; inactive member Oregon Bar; Clerk to William McAllister, Oregon Supreme Court, 1967.

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

2. *See*, *e.g.*, JOSEPH BLASI ET AL

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

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

In 1973, Kelso gained the ear of Senator Russell Long, the son e.

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

In the next decade, Senator Long secured the passage of some 1

Following Kelso's views,[23] Senator Long saw the ESOP as a vehicle for broadening capital ownership, not a means of achieving industrial democracy. While the Revenue Act of 1978 gave employees certain limited voting rights to their trust accounts,[24] he opposed any extension of these rights on the ground that it would discourage adoption of ESOPs.[25] The ESOP provisions engrafted on ERISA place control of employer stock in the hands of a trustee who is ordinarily appointed by the employer's board of directors.[26] During their employment, employees enjoy only a beneficial ownership in the employer stock, shorn of ordinary shareholder rights;[27] and upon retirement or severance of employment, they receive a distribution of their individual accounts either in stock or cash.[28] Some ESOPs involving direct contributions of stock to the trust represent a minor variation on the stock bonus plans pre-dating ERISA. But leveraged ESOPs, which link employee rights to repayment of the initial financing, have come to dominate the field.[29] The trust purchases the stock by a bank loan guaranteed by the employer or by a direct loan from the employer.[30] Then, as the loan is paid off, the employees' beneficial interest in the trust is allocated to their individual accounts.[31]

From its inception, the recognition of the ESOP as a stock bonus plan entailed a favorable tax consequence that served Kelso's vision of a new financing device to broaden capital ownership—it allowed the employer to pay off the ESOP loan with deductible contributions to the ESOP trust.[32] The effect, as now codified, is to give the employer access to funds through a sale of stock to the ESOP, which are financed by a uniquely tax-advantaged loan in which principal as well as interest payments are tax deductible.[33] During the last twelve years of Long's Senate career, Congress enacted a medley of additional tax incentives for ESOPs.[34] Congress later repealed some of these tax breaks, including tax credits, an estate tax deduction, and tax exclusion on interest from ESOP loans,[35] but the ESOP remains highly tax-favored. It enjoys the tax benefits available generally to qualified retirement plans: deduction of employer contributions to the plan,[36] exemption of trust from taxation on earnings,[37] and employee tax deferrals upon ultimate distribution of their individual accounts.[38] In addition, the tax code allows employers to deduct payment of dividends to stock held by an ESOP[39] and promotes the iJT*-0o5brib[(to the ESOP trust.)0.1 Tm0.2917

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

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

42. The reasons included a declining interest in ESOPs as a takeover defense as the phenomenon of hostile takeovers receded; a change in accounting rules for valuing allocations to individual accounts that reduced the corporations reported earnings; and the increased competition from broadly based stock options. *See tition from broa*