Risky Retirement Business: How ESOPs Harm the Workers They Are Supposed to Help

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I. INTRODUCTION

When Enron Corporation collapsed in late 2001, many of the company's employees lost all or part of their retirement savings. At the same time, they were losing their jobs, health insurance, and other benefits of employment. The reason so many workers lost their retirement savings when Enron went bankrupt was that a large portion of their stake in the company's retirement plans was invested in Enron's own stock.[1]

Since Enron's downfall, many have commented on the dangers that arise when "401(k)"-type retirement plans are structured, as was Enron's largest plan, to invest substantially in the stock of the employing company.[2] In simple terms, such investment over-concentrates the worker-participants' retirement savings in a single investment, exposing them to a dangerous level of investment risk. Employees could avoid this peril if their retirement plan assets were in a properly diversified portfolio instead.

Employee Stock Ownership Plans ("ESOPs")—retirement plans that invest almost entirely in stock of the employing company[3]—greatly intensify the under-diversification problem. From a diversification perspective, ESOPs are "Enron on steroids," because they concentrate an even larger portion of each participant's retirement savings in employer stock. There are roughly six times as many 401(k) participants as ESOP participants, but the ESOP participants have about three times as much money invested in employer stock: to the tune of some $800 billion.[4] Moreover, the portion of 401(k) assets invested in

1. More than half of the assets in Enron's 401(k) retirement plan were invested in Enron stock, *In re* Enron Corp. Securities, Derivative, & ERISA Litigation, No. MDL 1446, Civ.A. H-01-3913, 2006 WL 1662596, at *4 n.12 (S.D. Tex. June 7, 2006), and the plan lost some $1.3 billion, David Millon, *Enron and the Dark Side of Worker Ownership*, 1 SEATTLE J. SOC. JUSTICE 113, 118 (2002).

2. *See, e.g.*, Shlomo Benartzi et al., *The Law and Economics of Company Stock in 401(k) Plans*, 50 J.L. & ECON. 45, 53–56 (2007) (discussing employees' understanding of the risk of owning company's stock); Richard L. Kaplan, *Enron, Pension Policy, and Social Security Privatization*, 46 ARIZ. L. REV. 53, 71–77 (2004) ("some 30 [percent] of 401(k) assets are invested in the sponsoring corporation's stock"); Susan J. Stabile, *Another Look at 401(k) Plan Investments in Employer Securities*, 35 J. MARSHALL L. REV. 539, 539 (2002) (arguing that "more regulation of 401(k) investments in employer securities is warranted and that such regulation must involve more than just disclosure and education").

3. *See* I.R.C. § 4975(e)(7) (2006) (defining employee stock ownership plan in part as a plan "designed to invest primarily in qualifying employer securities").

4. There are approximately 10 million ESOP participants in the U.S., and, in 2006, there were over 57 million participants in 401(k) and profit sharing plans. *See* THE ESOP ASSOCIATION,

employer stock has been declining for some years.[5] By definition, ESOPs continue to invest most of their assets in employer stock, and the total assets at stake have increased over time.[6]

ESOP participants can do well as long as the company's stock price rises, but if the company runs into difficulties, ESOP participants are dramatically more vulnerable than participants in better-diversified retirement plans. For example, when UAL Corporation, which is the parent company of United Airlines, experienced heavy losses and went bankrupt in 2001-2002, participants in its ESOP permanently lost about $2 billion in stock value.[7] Even for the average ESOP participant whose company does not go "belly-up," the ESOP's lack of diversification can significantly reduce the funds available for retirement.

In addition to extreme under-diversification, ESOPs create numerous opportunities for company insiders to advance their own interests at the expense of the workers whom the ESOP supposedly benefits. Company insiders and the "fiduciaries" they choose to represent the participants

ESOP STATISTICS, http://www.esopassociation.org/media/media_statistics.asp (last visited Feb. 16, 2009) (giving figure of 10 million ESOP participants); COREY ROSEN, THE NAT'L CTR. FOR EMPLOYEE OWNERSHIP, THE EMPLOYEE OWNERSHIP UPDATE, http://www.nceo.org/main/column.php/id/247 (last visited Feb. 16, 2009) (stating figure of 11.2 million participants, of whom 630,000 belonged to profit sharing plans invested primarily in employer stock, rather than ESOPs); U.S. DEP'T OF LABOR, EMPLOYEE BENEFITS SECURITY ADMINISTRATION, PRIVATE PENSION PLAN BULLETIN: ABSTRACT OF 2006 FORM 5500 ANNUAL REPORTS 41 (2008) [hereinafter U.S. DEP'T OF LABOR 2006] (reporting number of participants in "401(k)-type" plans). ESOP assets have been estimated at about $800 billion, while employer stock in 401(k)-type plans was roughly $230 billion in 2006. THE ESOP ASSOCIATION, *supra* (estimating $800 billion in ESOP assets); U.S. DEP'T OF LABOR 2006, *supra*, at 45 (estimating $229,947,000,000 in employer stock in 401(k)-type plans in 2006). ESOPs generally maintain a small portion of their assets outside employer stock, but the total invested in such stock is still huge.

5. *See* Jack VanDerhei et al., *401(k) Asset Allocation, Account Balances, and Loan Activity in 2006*, 308 EMPLOYEE BENEFIT RESEARCH INST. ISSUE BRIEF 1, 26 (Aug. 2007) (reporting decline in share of 401(k) account assets invested in company stock from 19 percent in 1996 to 11 percent in 2006); William J. Wiatrowski, *401(k) Plans Move Away from Employer Stock as Investment Vehicle*, 131 MONTHLY LAB. REV. 3, 3–10 (2008) (highlighting the large decreases between 1985 and 2005 in 401(k) plans allowing investment in employer stock).

6. In 2003, for example, total ESOP assets were just over $620 billion, U.S. DEP'T OF LABOR, EMPLOYEE BENEFITS SECURITY ADMINISTRATION, PRIVATE PENSION PLAN BULLETIN: ABSTRACT OF 2003 FORM 5500 ANNUAL REPORTS 50 (2006), compared to $800 billion in 2006, *see* U.S. DEP'T OF LABOR 2006, *supra* note 4. It is safe to assume that total ESOP assets have leveled off or declined with the severe market setbacks of 2008–2009, but the longer-term increases are the point.

7. *See* Summers v. UAL Corp., No. 03 C 1537, 2005 WL 2648670, at *1 (N.D. Ill. Oct. 12, 2005), *aff'd sub nom.* Summers v. State St. Bank & Trust Co., 453 F.3d 404 (7th Cir. 2006). The ESOP at UAL, which actually consisted of two separate ESOPs, was terminated in 2003. Summers v. State St. Bank & Trust, 920 F. Supp. 924, 925 (N.D. Ill. 1996), *aff'd*, 104 F.3d 105, 106 (7th Cir. 1997); *In re* UAL Corp., 412 F.3d 775, 777 (7th Cir. 2005).

face myriad conflicts of interest, from decisions to institute an ESOP, to determinations about whether and at what price the ESOP should buy shares of company stock, to choices about how to vote the shares held in the ESOP.

Despite these problems, federal law encourages employers to adopt ESOPs through tax incentives and exceptions from the rules that govern other retirement plans. ESOP advocates defend this favorable treatment, insisting that ESOPs are good for workers. Their arguments take two basic forms, both of which share the notion that ESOPs are instruments of economic democratization. The first type of argument, once common but currently rare, asserts that ESOPs promote "democratic capitalism" by turning the great mass of workers into owners of capital and reducing wealth and income disparities. The second, more current argument is that ESOPs empower worker-participants with a greater sense of ownership and commitment with respect to their employers and their work. In turn, the argument goes, this changed attitude leads to increases in worker satisfaction and productivity, which enable employers to keep workers employed for longer and to compensate them better.

After more than five decades of experience with ESOPs, however, there is little evidence to support these claimed benefits. Today, even ESOP advocates concede that ESOPs do not significantly alter existing patterns of wealth or income distribution. As to the more modest claims of enhanced satisfaction and productivity, empirical studies are at best inconclusive and do not show that any benefits for workers are clearly traceable to ESOPs as such.

Even if there were compelling evidence that ESOPs help workers in any or all of the ways advocates claim they do, we should balance such benefits against the costs of forcing workers to participate in undiversified retirement plans rife with conflicts of interest. The problem would be somewhat less severe if workers were otherwise diversified, but workers who participate in ESOPs tend to have little or no capital investment outside their homes and retirement plans.[8] Thus,

8. In 2002, nearly 52 percent of American households owned some stock, either directly, indirectly, or beneficially; of those households, however, 66 percent held stock through employer-based retirement plans, and only 17 percent held stock both through such plans and directly. Robert Hockett, *What Kinds of Stock Ownership Plans Should There Be? Of ESOPs, Other SOPs, and "Ownership Societies,"* 92 CORNELL L. REV. 865, 875 (2006–2007). As of 2001, the bottom 80 percent of Americans in terms of total wealth held only 10.7 percent of all stock. G. William Domhoff, *Wealth, Income, and Power*, WHO RULES AMERICA, Sep. 2005, http://sociology.ucsc.edu/whorulesamerica/power/wealth.html (last visited May 20, 2009) (citing Edward N. Wolff, *Changes in Household Wealth in the 1980s and 1990s in the U.S.* (2004) (unpublished manuscript)). In 2004, however, the bottom 90 percent held 41.7 percent of all

ESOPs place in jeopardy the retirement savings of those least able to bear the risks of non-diversification and inherent conflicts of interest. On balance, incentivizing ESOPs does workers much more harm than good.

Part II explains why ESOPs are inherently risky retirement investment vehicles and outlines the federal law that permits and encourages ESOPs. Then, Part III describes the conflicts of interest inherent to ESOPs. Part IV critically addresses the claim by ESOP advocates that ESOPs promote economic democratization. Part V considers various reform strategies for addressing the problems identified. Part VI briefly addresses implications for other areas of inquiry, and Part VII concludes.

II. ESOPs, NON-DIVERSIFICATION, AND FEDERAL LAW

The ESOP at United Airlines' ("United") corporate parent, UAL, arose from a background of labor turmoil and poor profits.[9] In exchange for the ESOP's ownership of a majority share in the company, the unions representing United's pilots and mechanics, as well as some non-unionized employees, accepted lower pay and poorer fringe benefits.[10] Even though the 18,000-member flight attendants' union declined to participate,[11] United insiders and government officials alike celebrated the ESOP arrangement. The chairman of the company's board of directors said United had "forged a link between each employee and every activity and the overall health of this company. We no longer have employees working for a company; we have employees who *are* the company."[12] Labor Secretary Robert Reich commented that, "[f]rom here on in, it will be impossible for a board of directors to not consider employee ownership as one potential business strategy."[13]

As noted above, the tragic end of the UAL ESOP story is that the participants lost about $2 billion in just over a year.[14] But even when

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pension account assets. *Id.* (citing Edward N. Wolff, *Recent Trends in Household Wealth in the United States: Rising Debt and the Middle-Class Squeeze* 27 (The Levy Economics Institute of Bard College, Working Paper No. 502, 2007)). The bottom 80 percent in 2004 held only 7.5 percent of the nation's financial wealth, which excludes home equity but includes cash surrender value of retirement plan accounts. *Id.*

9. *Summers*, 920 F. Supp. at 925.

10. *Summers*, 104 F.3d at 106; Adam Bryant, *After 7 Years, Employees Win United Airlines*, N.Y. TIMES, July 13, 1994, at A1.

11. *Union Ends UAL Talks*, N.Y. TIMES, Aug. 31, 1994, at D4.

12. Bryant, *supra* note 10.

13. *Id.*

14. Summers v. UAL Corp., No. 03 C 1537, 2005 WL 2648670, at *1 (N.D. Ill. Oct. 12, 2005), *aff'd sub nom.* Summers v. State St. Bank & Trust Co., 453 F.3d 404 (7th Cir. 2006).

the companies and the numbers are smaller, participants stand to suffer greatly. For instance, a mail-order company called Foster & Gallagher, Inc. went under in the late 1990s, and the net value of the shares held in its ESOP fell from $82 million to zero.[15] As a result, the employees lost their jobs and current benefits, and the ESOP's more than 4,000 participants also lost a great deal of their retirement savings, all in a single stroke.[16] In another published case, ESOP participants at Kroy, Inc.—which was in the printing and typography business—lost $35.25 million in stock value when the company went bankrupt.[17] These examples illustrate how the failure of an ESOP company can deprive workers of their employment, current benefits, and retirement savings.

Participants in the ESOP at the Tribune Company escaped serious loss to their retirement savings, but only because the ESOP had not been in place for very long when the giant publishing company filed for bankruptcy.[18] Nonetheless, Tribune employees still paid because, in setting up the ESOP, Tribune cut back its contributions to the company's 401(k) retirement plan.[19] Thus, when the company stock the ESOP held became essentially worthless, the employees suffered a net loss of retirement savings.

Of course, some ESOP companies perform well, and, so long as it lasts, that rising tide benefits the ESOP's participants as they retire and "cash out" the employer stock that they hold through the plan. The possibility of favorable results for some fortunate ESOP participants, however, is part and parcel of ESOPs' radical under-diversification. Moreover, even in companies that do not collapse, ESOPs on average

15. *See* Keach v. U.S. Trust Co., 313 F. Supp. 2d 818, 824, 861 (C.D. Ill. 2004), *aff'd*, 419 F.3d 626 (7th Cir. 2005) (holding that any loss to ESOP was not caused by any breach of fiduciary duty by trustee in relying on inadequate legal due diligence conducted by counsel). In the interest of full disclosure, I was one of the attorneys for the plaintiffs in the *Keach* case.

16. *See id.* Regarding the number of participants, see Brief for Plaintiffs-Appellants at 2, Keach v. U.S. Trust Co., 419 F.3d 626 (7th Cir. 2005) (No. 04-1901), 2004 WL 3760879.

17. Reich v. Valley Nat'l Bank of Ariz., 837 F. Supp. 1259, 1262, 1270–71 (S.D.N.Y. 1993). The court in *Reich* determined that the ESOP suffered only $17.25 million in damages because it had repaid $17.5 million of the $35.5 million purchase price of its shares, and it received $250,000 for the shares in the Kroy bankruptcy. The Kroy ESOP's original investment of $17.5 million was worth nothing at the time of the collapse of Kroy. *Id.* at 1288–89.

18. *See* COREY ROSEN, THE NAT'L CTR. FOR EMPLOYEE OWNERSHIP, WHAT WILL HAPPEN TO THE ESOP IN THE TRIBUNE BANKRUPTCY?, http://www.nceo.org/library/tribune-esop-bankruptcy.html (last visited Feb. 16, 2009); *see also* Emily Thornton, *Tribune Bankruptcy Snares Employees*, BUS. WK., Dec. 8, 2008, http://www.businessweek.com/bwdaily/dnflash/content/dec2008/db2008128_376528.htm?chan=top+news_top+news+index+-+temp_news+%2B+analysis (explaining the short time the Tribune's ESOP was in place before the company declared bankruptcy).

19. *See* Thornton, *supra* note 18.

leave workers worse off than they would be with a diversified retirement plan.

A. ESOPs and Non-Diversification

Diversification is a fundamental principle of sound investment. ESOPs, by definition, are not diversified, meaning they expose their participants to a great deal of investment risk. That risk, moreover, provides no benefit to the participants in comparison with more diversified investments.

Under the widely accepted "modern portfolio theory," investments are considered not individually, but as part of a portfolio of investments.[20] Every investment has an expected rate of return, as well as an associated level of risk that the actual return will be less than the expected return.[21] Some of that risk is "market" or "systematic" risk, meaning it is inherent to the capital market system and cannot be diversified away.[22] Significant portions of the risk of any investment, however, are either "specific" risks peculiar to the firm invested in or risks associated with investments in a given industry or sector of the economy.[23] Investors can reduce the latter two types of risk, referred to together as "residual" risks, by diversifying their investments.[24] In other words, investors can, in large part, guard against residual risks by investing some of their money in other enterprises, industries, and sectors that have different sets of residual risks.[25]

For purposes of this Article, the key insight of modern portfolio theory is that, for any single investment, one can select a diversified portfolio of investments that provides the same expected return, but with a lower level of risk. An investor in a single stock or other investment has an expected return that correlates to the market's

20. ROBERT L. HAGIN, THE DOW JONES-IRWIN GUIDE TO MODERN PORTFOLIO THEORY 143 (1979).

21. *See id.* at 99–102, 183.

22. *See id.* at 101–02; Robert J. Aalberts & Percy S. Poon, *The New Prudent Investor Rule and the Modern Portfolio Theory: A New Direction for Fiduciaries*, 34 AM. BUS. L.J. 39, 59 (1996) (explaining that non-diversifiable risk "includes changes in inflation and interest rates that affect the whole economy"); Paul G. Haskell, *The Prudent Person Rule for Trustee Investment and Modern Portfolio Theory*, 69 N.C. L. REV. 87, 101 (1990) (explaining that "all stocks are affected by this risk in the same way, albeit in different degrees").

23. HAGIN, *supra* note 20, at 101–02.

24. *Id.* at 102, 183. Additional names for residual risk include "unsystematic" and "selection" risks. *Id.* at 183.

25. *Id.* at 101–03. In slightly more technical terms, the investor should seek investments that "covary negatively" to as great a degree as possible with respect to the firm- and industry-specific risks they entail. *See* Haskell, *supra* note 22, at 101–02.

valuation of that investment's market risk.[26] In an efficient market, higher levels of market risk correlate with higher expected returns.[27] Because well-informed investors can diversify away residual risk, the system of capital markets compensates investors only for taking on market/systematic risks; it does not provide additional returns for taking on residual risks.[28]

If an investor puts all of her money in a single investment, then, she has incurred residual risk in addition to the market risk, but she receives no additional return to compensate for that risk.[29] As a result, investment in a single security can never be "efficient," meaning that it can never be the investment choice with "the lowest level of transaction costs and risks for a particular expected return[,] or vice versa."[30]

A concentrated investment in employer stock increases the worker's risk of catastrophic loss in the event the employer's business collapses. Even if a catastrophe does not occur, though, undiversified investments cause workers real harm. Due to the fact that the stock's return is determined by the company's market risk, and the investor receives no additional return for the residual (that is, diversifiable) risk, the stock's return is insufficient to compensate the investor for the full amount of market and residual risk she bears.[31] As a result, a large investment in employer stock that the employee holds for a long period has an effective value of far less than the stock's market value.[32] For workers with large portions of their pension savings in employer stock over a

26. Haskell, *supra* note 22, at 102.

27. *See, e.g.*, Aalberts & Poon, *supra* note 22, at 59–60 ("[T]he capital market will reward securities according to their betas, but not their standard deviation or stand alone risks.").

28. *Id.* at 183; Haskell, *supra* note 22, at 101–03.

29. Haskell, *supra* note 22, at 102–03.

30. Aalberts & Poon, *supra* note 22, at 65.

31. *See* Lisa Meulbroek, *Company Stock in Pension Plans: How Costly Is It?* 15 (Harvard Bus. School, Working Paper No. 02-058, 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=303782 (stating that in order to provide adequate compensation to undiversified employees, "the expected return on company stock would need to be commensurate with its *total* volatility"); *see also* Olivia S. Mitchell & Stephen P. Utkus, *Company Stock and Retirement Plan Diversification* 35 (Pension Research Council, Working Paper 2002-4, 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=304461 (projecting that over 30-year period, diversified portfolios would have just over twice median value of portfolio composed of 100 percent company stock). *Cf.* William E. Even & David A. Macpherson, *Pension Investments in Employer Stock* 23–33 (IZA Discussion Paper No. 2376, Oct. 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=941110 (finding negative effects on portfolio performance concentrated in hypothetical portfolios with between 50 and 100 percent of employer stock).

32. Meulbroek, *supra* note 31, at 25–26, *cited in* Benartzi et al., *supra* note 2, at 47, 49–50.

number of years, the effective value can be far less than 50 cents on the dollar.[33]

From the perspective of sensible investment principles, therefore, ESOPs are anathema. They concentrate participants' retirement savings in the stock of a single employer, thereby exposing those savings to the full range of industry- and firm-specific risks associated with that stock. But the non-diversification problem does not end there. ESOPs also make workers' retirement savings dependent on the exact same set of risks that already affect most participants' current income and non-retirement benefits, including such vital resources as health insurance.

If the employing company falls on hard times, it is likely to carry out layoffs at the same time that its stock's value is declining.[34] The workers who lose their jobs and, therefore, their current benefits, will simultaneously face a decline in the value of their retirement accounts. Given that workers in dire financial straits might need to take loans from retirement savings in order to cover short-term needs, the drop in stock value comes at a particularly inopportune moment.[35] If the decline worsens and the employer fails, ESOP participants stand to lose nearly everything all at once: their jobs, their health insurance and other current benefits, and their retirement savings.

From a diversification perspective, a worker would be better off if the fiduciaries of his retirement plan randomly selected a single stock other than that of the employing company and invested all of the worker's retirement savings in that stock. The worker's investments would still be radically under-diversified, but at least they would not be tied to the same company as his pay and current benefits.

When confronted with ESOPs' inherent, radical under-diversification, ESOP advocates like to point out that a fair number of companies with ESOPs also have a 401(k) or some other, more diversified plan.[36] Assuming its accuracy, this notion inadequately addresses the under-diversification problem. A study ESOP advocates frequently cite, conducted among companies in the state of Washington, showed that workers who participated in both an ESOP and another

33. *Id.* at 25–26.

34. *See* Kaplan, *supra* note 2, at 76 (stating that the decline of a company's stock value often reflects negative economic situation in the company, which, in turn, leads to employee layoffs as well).

35. *See id.* at 77 ("[E]mployees may need to tap their retirement plan's assets to pay for living costs, health care expenses, and the like.").

36. *See, e.g.*, COREY ROSEN ET AL., EQUITY: WHY EMPLOYEE OWNERSHIP IS GOOD FOR BUSINESS 14–15 (2005) (claiming that "more than 80 percent" of ESOP companies offer "diversified 401(k) plans or other diversified retirement programs" to employees).

plan had an average of 60 percent of their total retirement savings in employer stock.[37] Leading ESOP advocates concede that anything more than 20 percent is "probably too much concentration in a single asset."[38] Thus, merely having an additional plan available does not adequately remedy ESOPs' under-diversification.

B. Federal Law Exceptions and Incentives for ESOPs

Over the years, federal law has taken some steps toward recognizing the importance of diversification in retirement savings. At each stage, however, Congress has exempted ESOPs from the resulting rules. For example, under the Employee Retirement Income Security Act ("ERISA"), the fiduciaries controlling a retirement plan's assets ordinarily have a duty to diversify the plan's investments.[39] That duty, however, does not extend to investments in employer stock by ESOPs and most other "defined contribution" plans,[40] including 401(k) plans.[41]

37. PETER A. KARDAS ET AL., NAT'L CTR. FOR EMPLOYEE OWNERSHIP, WEALTH & INCOME EFFECTS OF EMPLOYEE OWNERSHIP (1988), *available at* http://dept.kent.edu/oeoc/PublicationsResearch/Sum1999/WealthSum1999.html. Citations of this study by ESOP advocates tend to emphasize findings that ESOP companies in the study provided higher wages and benefits than non-ESOP "counterparts." *See, e.g.*, THE ESOP ASS'N, CORPORATE PERFORMANCE, http://www.esopassociation.org/media/media_corporate.asp (last visited May 20, 2009).

38. ROSEN ET AL., *supra* note 36, at 15.

39. Employee Retirement Income Security Act of 1974 (ERISA) § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C) (2006) (requiring fiduciaries to "diversify[] the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so").

40. Federal law divides retirement plans into "defined benefit" plans and "defined contribution" (or "individual account") plans. A defined contribution plan "provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account." *Id.* § 3(34), 29 U.S.C. § 1002(34). A defined benefit plan is, with some simplification, any plan that is not a defined contribution plan. *Id.* § 3(35), 29 U.S.C. § 1002(35). As the names suggest, defined benefit plans promise a certain output, in the form of benefits, whereas defined contribution plans promise a certain input, in the form of contributions to participants' accounts.

41. *Id.* § 404(a)(2), 29 U.S.C. § 1104(a)(2) (exempting "eligible individual account plans" from duty to diversify with respect to employer stock); *id.* § 407(d)(3), 29 U.S.C. § 1107(d)(3) (defining "eligible individual account plan"). In the 401(k) context, most plans today allow participants to direct their own investments, at least as to amounts participants invest by way of salary deferrals. If the plan implements participant direction properly, the plan's fiduciaries are not responsible for the consequences of participants' investment choices. *See id.* § 404(c), 29 U.S.C. § 1104(c) (addressing fiduciary duties). They often remain responsible, however, for employer "matching" contributions made in the form of employer stock, which is where they benefit from being exempt from the fiduciary diversification requirement. ESOP fiduciaries make all the plan's investment decisions and simply could not maintain the plan as an ESOP if the diversification duty applied.

In addition, federal regulations require that fiduciaries consider the place of individual investments within the plan's larger portfolio—an apparent nod in the direction of modern portfolio theory.[42] Like the diversification rule, however, this requirement exempts ESOPs and other defined contribution plans when it comes to investment in employer stock.[43]

In the wake of Enron's meltdown, Congress passed new laws for 401(k) and similar retirement plans, mandating that participants have the option to diversify their investments out of employer stock.[44] Those new diversification requirements, though, do not apply to ESOPs.[45] Instead, ESOPs remain subject to a much more limited, pre-Enron diversification requirement.[46]

Besides exempting ESOPs from the most significant diversification rules, Congress also actively encourages companies and their insiders to adopt and keep ESOPs. ESOP companies receive several major tax incentives not available to other, better diversified retirement plans. To mention only one example, when a shareholder sells stock to an ESOP that owns, after the transaction, at least 30 percent of the company, the

42. *See* 29 C.F.R. § 2550.404a-1(b)(1)(i) (2009) (requiring fiduciaries to "give[] appropriate consideration to . . . the role [an] investment . . . plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties"). For a discussion of the impact of modern portfolio theory on non-ERISA fiduciary investing, see Aalberts & Poon, *supra* note 22, at 39.

43. In addition to exempting ESOPs' holding of employer stock from the specific duty to diversify, Section 404(a)(2) also lifts "the prudence requirement (only to the extent that it requires diversification) of paragraph [404(a)](1)(B)." ERISA § 404(a)(2), 29 U.S.C. § 1104(a)(2). The regulatory requirement that fiduciaries consider how an investment relates to the plan's portfolio clarifies the § 404(a)(1)(B) prudence requirement. *See* 29 C.F.R. § 2550.404a-1(b)(1)(i) (explaining the investment duties of the fiduciary).

44. Put simply, non-ESOP defined contribution plans that hold publicly traded employer stock must now allow participants to diversify all of their own plan contributions out of employer stock immediately and to diversify the employer's contributions after a participant has been part of the plan for three years. *See* I.R.C. § 401(a)(35) (2006) (detailing the diversification requirements for certain defined contribution plans); ERISA § 204(j), 29 U.S.C. § 1054(j) (outlining the diversification requirements for certain individual account plans). Plans that permit participants to direct the investment of their own accounts must also provide participants with information regarding the importance of retirement investment diversification. *See* ERISA §§ 101(m), 105(a)(2)(B), 29 U.S.C. §§ 1021(m) (containing the notice of right to invest), 1025(a)(2)(B) (describing the requirements to provide pension benefit statements).

45. I.R.C. § 401(a)(35)(E) (defining "applicable defined contribution plan[s]" to which diversification rules apply).

46. An ESOP does not need to provide any opportunity to diversify at all until a participant reaches age fifty-five and has at least 10 years of participation in the ESOP. *Id.* § 401(a)(28). Even then, the plan only has to let the participant diversify one-quarter of what he has in the plan. *Id.* At age sixty, the portion expands to one-half. *Id.*

shareholder can defer paying tax on any gain realized in the sale, merely by buying other securities with the proceeds.[47]

As a result of the incentives, ESOPs appear to many employers and company insiders as an attractive means of accomplishing a variety of goals, only a few of which have anything to do with providing employees with secure retirement savings. In addition, as discussed in the next Part, these incentives also give rise to a host of conflict of interest problems.

III. ESOPS AND CONFLICTS OF INTEREST

ESOPs create a range of serious conflicts of interest that either do not affect other retirement plans, or affect them to a lesser degree. Moreover, those additional conflicts are not necessary to the central ERISA goal of maintaining secure, employer-based retirement plans.[48]

47. *See id.* § 1042 (discussing requirements to qualify for nonrecognition of gain). In addition, ESOPs receive other tax advantages. In other types of "tax-qualified" retirement plans, the employer may deduct from its gross income its contributions to the plan, up to certain limits. *Id*. § 404(a)(3). An ESOP sponsor may exceed those limits if the contributions go to pay down the loan used to acquire the ESOP's shares of employer stock: it may deduct payments of loan principal up to similar limits, but it may deduct without limit payments of interest on the loan. *Id.* § 404(a)(9). In addition, the sponsoring company may deduct any dividends paid on stock held by the ESOP, whether the dividends go to the participants or go to pay down the ESOP loan. *See id.* § 404(k) (addressing the deduction for dividends paid on certain employer securities). Beyond the benefits to companies and insiders, tax law also privileges participants in ESOPs. A participant taking a lump sum distribution of employer stock from an ESOP at retirement does not have to pay ordinary income tax on any "net unrealized appreciation" on the employer stock over and above the price the ESOP paid for the shares. *Id.* § 402(e)(4)(B). Instead, the participant pays tax on the appreciation at the lower long-term capital gains rate, whenever she sells the employer stock. *See* LOUIS O. KELSO & PATRICIA H. KELSO, DEMOCRACY AND ECONOMIC POWER: EXTENDING THE ESOP REVOLUTION 62 (1986) ("All income taxation of employees on the value of ESOP-acquired stock is deferred from the time the ESOP pays for their stock until the time the employee retires or separates from the employer."). If she passes the stock onto her heirs, they get a "step-up" in basis, meaning no tax will be paid on the appreciation.

Congress in 1996 repealed a provision allowing entities lending money to ESOPs for purchases of employer stock to deduct up to fifty percent of the interest received from their taxable income. *See* I.R.C. § 133 *repealed by* Small Business Job Protection Act of 1996, Pub. L. No. 104-188 § 1602(c), 110 Stat. 1833 (1996) (detailing that interest on certain loans is used to acquire employer securities). The numbers of ESOPs and participants, however, continue to grow, and some three-quarters of ESOPs in existence either are or have been leveraged. *See* NAT'L CTR. FOR EMPLOYEE OWNERSHIP, A STATISTICAL PROFILE OF EMPLOYEE OWNERSHIP, http://www.nceo.org/library/eo_stat.html (Feb. 2008) (last visited Feb. 16, 2009) (citing 9,225 ESOPs "and equivalent plans" in 1993, 7,600 in 1999, and 9,774 in 2007, with increase in participants from 7.5 million to 11.2 million between 1993 and 2007); THE ESOP ASSOCIATION, *supra* note 4 (stating that at least seventy-five percent of ESOP companies are or were leveraged, meaning they used borrowed funds to acquire the ESOP's employer securities).

48. ERISA is generally understood as having dual goals: protecting employee benefits and encouraging employers to maintain benefit plans. *See* Metro. Life Ins. Co. v. Glenn, 128 S. Ct.

These "extra" conflicts mean ESOP participants are more vulnerable than necessary to being victimized by the company and its insiders. This Part will describe the three areas of additional conflict that ESOPs create. First, it will address conflicts relating to the formation of ESOPs. Second, it will outline the conflicts involving ESOP transactions in employer stock. Third, it will explain conflicts connected to voting the ESOP's shares of employer stock. Finally, this Part will explain how ESOPs differ from other retirement plans with respect to conflicts of interest and will then conclude that the additional conflicts associated with ESOPs are unnecessary in light of ERISA's central purposes.

A. Conflicts of Interest Relating to ESOP Formation

The first conflict of interest arises when company insiders decide whether to form an ESOP as opposed to some other, more diversified type of retirement plan. Plan formation decisions are not subject to the limits ERISA places on the conduct of plan fiduciaries.[49] Other ERISA rules, which on their face seem to prohibit ESOPs, contain exceptions specifically designed to allow them.[50] As a result, an employer can institute a plan that requires workers to invest their retirement savings solely in employer stock, it can do so for reasons that have nothing to do with improving the lot of the workers, and the workers have no grounds under the statute to complain.[51]

The decision by an employer to institute an ESOP involves a number of potential considerations that are unique to ESOPs. First, an ESOP can be an effective means of raising capital. As many as seventy-five

2343, 2349 (2008) (noting "Congress' desire to offer employees enhanced protection for their benefits") (citation omitted); Varity Corp. v. Howe, 516 U.S. 489, 497 (1996) (describing "Congress' . . . desire not to create a system that is so complex that administrative costs, or litigation expenses, unduly discourage employers from offering welfare benefit plans in the first place").

49. Those decisions are not subject to the ERISA fiduciary rules because, unlike the administration of an existing plan and the management of its assets, they are considered "settlor" rather than "fiduciary" decisions. *See, e.g.*, Lockheed Corp. v. Spink, 517 U.S. 882, 890 (1996) (stating rule that employers, in adopting, modifying, or terminating retirement plan, "do not act as fiduciaries . . . but are analogous to the settlors of a trust . . .").

50. *See* ERISA §§ 406(a)(1)(A), (B), (E), 29 U.S.C. §§ 1106(a)(1)(A), (B), (E) (2006) (listing "prohibited transactions," including "lending of money or other extension of credit between the plan and a party in interest" and "acquisition, on behalf of the plan, of any employer security . . . in violation of [a provision limiting employer stock to ten percent of a plan's assets]"); *id.* §§ 408(b)(3), (e), 29 U.S.C. §§ 1108(b)(3), (e) (removing ESOP loans and share transactions from realm of prohibited transactions).

51. To be sure, some—perhaps even many—insiders might genuinely believe ESOP advocates' claims that implementing an ESOP will be good for the employees as well as for the company and its high-level insiders.

percent of ESOPs are "leveraged," meaning that the plan borrows the money with which the ESOP buys company stock.[52] When the ESOP buys treasury stock, the company obtains debt financing with all the aforementioned tax advantages.[53] Those advantages can make a leveraged ESOP a source of capital preferable to other forms of debt financing and to equity financing.[54] Because ESOPs are the only type of tax-qualified retirement plan allowed to borrow money, this incentive does not arise with other plans.

Particularly in non-publicly traded companies, an ESOP can also be an attractive device for succession planning. A sole or majority owner of such a company who wishes to retire, or merely to diversify his holdings, can benefit from selling to an ESOP instead of some other purchaser.[55] For instance, the owner can defer indefinitely taxation on the capital gains from the sale, which can be a gigantic boon.[56] Other kinds of retirement plans, including 401(k) plans, do not carry the same tax advantages. Furthermore, 401(k) plans that invest in employer stock are more common in publicly, rather than non-publicly, traded companies.[57]

52. *See* THE ESOP ASSOCIATION, *supra* note 4 ("At least 75 percent of ESOP companies are or were leveraged . . . ."). For a basic description of a leveraged ESOP structure, see Hockett, *supra* note 8, at 888. Note, however, that in some leveraged ESOP transactions it is company insiders, rather than the company itself, who sell stock to the ESOP; in such transactions, the borrowed funds flow to insiders rather than to the company.

53. *See supra* note 47 and accompanying text.

54. *See supra* note 47 and accompanying text; Hunter C. Blum, Comment, *ESOP's Fables: Leveraged ESOPs and Their Effect on Managerial Slack, Employee Risk and Motivation in the Public Corporation*, 31 U. RICH. L. REV. 1539, 1546 (1997) (describing benefits of ESOPs as methods of capital formation). One estimate is that the tax advantages of ESOPs can reduce the cost of borrowing by as much as thirty-four percent. Ellen E. Schultz, *Tribune Filing Exposes Risks of ESOPs*, WALL ST. J., Dec. 10, 2008, at B6.

55. *See generally, e.g.*, ROBERT A. FRISCH, ESOP: THE ULTIMATE INSTRUMENT IN SUCCESSION PLANNING (2d ed. 2001) (discussing the rules by which ESOPs are governed and the situations in which ESOPs can be applied). Frisch, who runs a company specializing in implementing and managing ESOPs, *id.* at v, extols the succession-planning virtues of ESOPs in chapters with titles such as "How Mr. Big Sold His Company Tax Free and Still Kept It," *id.* at 173.

56. I.R.C. § 1042 (2006); *see also supra* note 47 and accompanying text.

57. The reasons for this tendency include I.R.C. § 401(a)(22), which requires most defined contributions plans with more than ten percent of assets in employer stock that is not "readily tradable on an established market" to pass through voting in compliance with I.R.C. § 409(e). *See infra* note 77 and accompanying text. In addition, a plan that allows participants to direct their own investments can shield plan fiduciaries from liability for any negative consequences of participants' decisions. *See* ERISA § 404(c)(1)(A)(ii), 29 U.S.C. § 1104(c)(1)(A)(ii) (2006). That shield, however, does not apply with respect to any participant instruction to acquire or sell employer stock that is not publicly traded. 29 C.F.R. § 2550.404c-1(d)(2)(ii)(E)(4)(iii) (2009). Some companies opt for an arrangement known as a "KSOP," which combines an ESOP and a 401(k).

Moreover, an ESOP can enable insiders to control the company without maintaining a large personal investment in its stock. The rules for voting of ESOP shares, described below, can make the ESOP into a "captive" block of stock subject to the will of the insiders.[58] Sam Zell, for instance, became the controlling voice in the Tribune Company even though he invested only about $315 million in the purchase of the company, which sold at over $8 billion.[59] The rest of the money came from a complex, leveraged ESOP arrangement.[60]

In a publicly held company, ESOP purchases of stock can provide support for the share price that might further serve the interests of insiders. Higher stock prices can raise insiders' compensation, both by making their stock options worth more and by triggering bonuses or other incentives tied to stock performance.[61] In addition, higher stock value can assist insiders in achieving desired mergers and acquisitions, because they can often provide the target company's shareholders with stock in the acquiring company rather than cash for at least part of the purchase price.[62]

All these interests increase the likelihood that companies will choose an ESOP over some other type of retirement plan. ESOPs' lack of diversification means that, viewed *ex ante*, they can never be in the participants' best interests.[63] For the lucky participants in some ESOPs, the plan will turn out to have been beneficial in comparison to a more diversified plan, but the same would be true if the employer decided to invest workers' retirement assets exclusively in some other company's stock, or even in lottery tickets. The company insiders' choice to start an ESOP, instead of a more diversified plan, means workers are less likely to have sufficient retirement resources. Choosing an ESOP, then, reflects either a misunderstanding of the workers' best interests or a deliberate subordination of those interests to the interests of the company and the insiders.

B. Conflicts of Interest in ESOP Transactions in Employer Stock

Further conflicts of interest arise in connection with an ESOP's decision to buy or sell particular shares of employer stock, either at the

58. *See infra* notes 76–82 and accompanying text.

59. Thornton, *supra* note 18.

60. *Id.*

61. As to the stock options point, see Kaplan, *supra* note 2, at 73.

62. *Id.* at 73–74 (explaining that the acquiring company can avoid or lessen the need to raise cash for the acquisition by using its own stock for all or part of the purchase price).

63. *See supra* notes 18–38 and accompanying text.

time of formation or later. The plan's fiduciaries must decide whether to complete the transaction and, if so, at what share price.

If the company's stock is publicly traded, as is the norm with 401(k) plans, then determining the share price is relatively straightforward.[64] But if the stock is not publicly traded, as is the case in nearly all ESOP companies, the determination becomes more complicated.[65] In non-publicly traded businesses, the company and its insiders are naturally the persons who have stock available; accordingly, either the company or the insiders are the ones proposing to sell shares of stock to the ESOP. Valuing stock that is not publicly traded is, at best, an inexact science,[66] and insiders naturally tend to prefer the highest price they (or the company) can get. The higher the share price, however, the fewer shares the ESOP will receive in exchange for the same initial investment of cash or debt. For most participants, therefore, a lower transaction share price is beneficial.[67]

In response to the rather apparent conflicts of interest, insiders of non-publicly traded companies typically find it necessary to hire a third party to act as an "independent fiduciary" and evaluate the proposed stock purchase on behalf of the ESOP's participants.[68] The outside fiduciary, in turn, often hires a valuation firm to value the company and help decide whether the proposed share price is "adequate."[69]

64. ESOPs and other "eligible individual account plans" may transact in employer stock so long as no commission is charged on the transaction, and the transaction is for "adequate consideration." ERISA § 408(e), 29 U.S.C. § 1108(e) (2006). For securities with a "generally recognized market," adequate consideration means the price at which the security trades on a registered exchange or a price no less favorable to the plan than the current bid and asked prices quoted by independent parties. *Id.* § 3(18), 29 U.S.C. § 1002(18).

65. *See* THE ESOP ASSOCIATION, *supra* note 4 (stating that only three percent of all ESOPs are in publicly traded companies, although those companies employ just under half of "the nation's 10 million employee owners").

66. *See* Rev. Rul. 59-60, 1959-1 C.B. 237, § 3.01 (recognizing valuation of shares in closely held companies is "not an exact science").

67. Participants who stand to retire very soon after the transaction might be indifferent to the transaction price, because the price at which they "cash out" any shares in their ESOP accounts will largely be driven by the transaction price. (If the transaction is leveraged, the cash out price will be lower than the transaction price, due to the company's taking on or guaranteeing the ESOP's purchase price debt). For those who retire later, however, a lower transaction price means more shares in the ESOP and more shares allocated to their accounts as the debt is paid down, which in turn means more cash for any given enterprise value at the time they retire. Or, if the ESOP buys the same number of shares for less money, participants benefit because the ESOP debt can be retired faster and/or because the company's obligation to service the debt is less, and the value of the company going forward is correspondingly higher.

68. *See, e.g.*, Keach v. U.S. Trust Co., 313 F. Supp. 2d 818, 834–35 (C.D. Ill. 2004), *aff'd*, 419 F.3d 626 (7th Cir. 2005) (describing retention of U.S. Trust Company as "independent" trustee to evaluate proposed share purchase by ESOP).

69. *See* ERISA § 3(18), 29 U.S.C. § 1002(18) (defining "adequate consideration" for

But the process of hiring outside fiduciaries and valuation companies does not effectively remedy the conflict of interest problem. The same insiders who stand to benefit from a high stock price also decide who will fill the fiduciary and valuation roles, usually as members of a committee set up to administer the ESOP.[70] Fiduciaries and valuation companies are almost always repeat players in the world of ESOP transactions, meaning that they are subject to significant pressure to please company insiders.[71] A provider of "independent" fiduciary services or a valuation firm that acquires a reputation in the market for being *too* independent—that is, for actually looking out for the interests of the plan participants, instead of those of the company insiders who make hiring decisions—risks a rapidly dwindling list of clients.[72] Simply put, this one-sided dynamic protects the well-being of company insiders while leaving exposed the workers whom the ESOP is supposed to benefit.

Unlike decisions about plan formation, decisions about share purchases and prices are fiduciary decisions under ERISA.[73] But ERISA's fiduciary rules provide only superficial checks on those decisions. Sophisticated fiduciaries and valuation experts can usually "paper the file" sufficiently to justify a share price favorable to the company and the selling insiders.[74] Challenging such determinations in

securities with no recognized market as "the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations").

70. Although the outside fiduciary is the party that formally retains the valuation expert, it is highly unlikely that the fiduciary would choose a firm that the company insiders opposed.

71. *See, e.g.*, *Keach*, 313 F. Supp. 2d at 834 (noting that the U.S. Trust had a "Special Fiduciary Committee" to oversee its service as institutional trustee in transactions involving ERISA issues and that "[o]nly a few firms and investment brokers provide this kind of specialized service").

72. There is nothing new about this pattern: a group of ostensibly independent watchdogs or arbiters favoring the interests of repeat players with either full or partial control over the selection process. *See, e.g.*, Richard L. Kaplan, *The Mother of All Conflicts: Auditors and Their Clients*, 29 J. CORP. L. 363, 367–68 (2004) (describing "coziness" of nominally independent auditors with clients, due in large part to clients' ability to fire auditors who show too much actual independence); Richard C. Reuben, *Constitutional Gravity: A Unitary Theory of Alternative Dispute Resolution and Public Civil Justice*, 47 UCLA L. REV. 949, 1066 (2000) (reporting findings of homogeneity and pro-repeat-player tendencies among arbitrators).

73. *See* ERISA §§ 406(a)(1)(A), (B), (E), 408(b)(3), (e)(1), 29 U.S.C. §§ 1106(a)(1)(A), (B), (E), 1108(b)(3), (e)(1) (prohibiting fiduciaries from transactions including ESOP loans and plan acquisition of employer stock, then removing such prohibitions if, *inter alia*, purchase is for "adequate consideration").

74. By "papering the file," I mean documenting such steps as site visits and interviews with company managers, reviews of industry-related research and publications, complex valuation methodologies, and reviews of actual or anticipated legal claims involving the company. *See, e.g.*, *Keach*, 313 F. Supp. 2d at 836–46 (describing actions taken and documented by trustee and

court is difficult and costly, and the applicable "good faith" standard can lead courts to accept the price that results from the fiduciary's process in the face of participants' claims that the price was too high.[75] In a sense the process is circular: what counts as a good faith process for determining the stock's fair market value tends to turn on what other, similarly conflicted fiduciaries and valuation experts have done in similar transactions.

C. Conflicts of Interest and Voting of Shares

Finally, ESOPs foment conflicts of interest with respect to the voting of the ESOP's shares. In publicly held companies, ESOP participants have the right to vote the shares allocated to their accounts as to all matters on which other shareholders can vote.[76] In non-publicly traded companies, where some 97 percent of ESOPs exist, the right to vote allocated shares is limited to certain types of major corporate decisions and does not extend to "routine" matters such as electing corporate directors.[77]

Participants' limited voting rights are further constrained when ESOPs are leveraged, which is true of as many as three-quarters of all ESOPs.[78] In a leveraged ESOP, shares are allocated to participants' accounts only gradually, in proportion to the amount of the loan principal the ESOP has paid off.[79] The rest of the shares remain unallocated, and the ESOP trustee retains discretion to vote those shares as part of its fiduciary role.[80] As a result, the participants in a leveraged ESOP do not gain the right to vote significant numbers of shares until

valuation company in evaluating proposed ESOP transaction).

75. *See supra* note 69 and accompanying text; *see also, e.g.*, Henry v. Champlain Enters., Inc., 445 F.3d 610, 620–21 (2d Cir. 2006), *vacated*, 569 F.3d 96 (2d Cir. 2009) (rejecting conclusion that ESOP fiduciary violated duties in approving share transaction at full price demanded by selling shareholders).

76. I.R.C. § 409(e)(2) (2006). Participant voting is referred to colloquially as "pass-through" voting.

77. *See id.* § 409(e)(3) (limiting voting when employer does not have a "registration-type class of securities" to "the approval or disapproval of any corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution, sale of substantially all assets of a trade or business, or such similar transaction as the Secretary may prescribe in regulations"). A pro-ESOP organization reports that only about 20 percent of private ESOP companies pass through full voting rights to participants. NAT'L CTR. FOR EMPLOYEE OWNERSHIP, *supra* note 47.

78. *See* THE ESOP ASSOCIATION, *supra* note 4 ("At least 75% of ESOP companies are or were leveraged . . . .").

79. *See* 29 C.F.R. § 2550.408b-3(h) (2009) (detailing the mechanism for determining the number of shares to be released over the term of the loan).

80. *See, e.g.*, Herman v. NationsBank Trust Co., 126 F.3d 1354, 1357 (11th Cir. 1997) (discussing "mirror voting" provisions and trustee's responsibility for voting unallocated shares, as well as allocated shares that participants neglect to vote).

years after the leveraged transaction, even though the ESOP might own a majority, or even 100 percent, of the employer's stock. Furthermore, even as to allocated shares, the trustee continues to vote shares that participants neglect to vote.

As a result of the limited voting rights afforded participants, company insiders can maintain effective control over matters committed to shareholder voting, even though they might directly own only a few shares or perhaps none at all. The trustee is generally a company insider or an outsider beholden to company insiders, so control of shareholder decisions remains with the insiders even if the ESOP holds a majority of the shares.[81]

It is easy to see why such an arrangement can be attractive to insiders. In a publicly traded company, an ESOP can provide a secure reservoir of votes to fend off unwanted takeover attempts.[82] Directors and managers can use the ESOP's shares to entrench their own positions: the trustee who is friendly with management votes to reelect incumbent directors, and the directors continue to employ, and generously compensate, the same trustee and management team.[83]

In a non-publicly traded company, because ESOP participants need not be allowed to vote even their allocated shares as to most matters, insiders need to own only a few shares in order to control most voting. If an owner wishes to complete a transaction as to which pass-through voting is required, such as a merger or a liquidation of the enterprise, she can usually rely on a friendly ESOP trustee to deliver the necessary votes.

The interests of the insiders can easily diverge from those of the ESOP participants in situations of shareholder voting.[84] To cite only

81. In the Tribune Company purchase, for instance, no one doubted that Sam Zell controlled the company, even though he did not own any shares. *See* Thornton, *supra* note 18.

82. *See, e.g.*, Blum, *supra* note 54, at 1547; Henry Hansmann, *When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy*, 99 YALE L.J. 1749, 1799–1800 (1990) (opining that managers' desire to protect themselves from hostile takeovers and direct accountability to workers at least partly explains creation of ESOPs without pass-through voting).

83. *See* Brett McDonnell, *ESOPs' Failures: Fiduciary Duties When Managers of Employee-Owned Companies Vote to Entrench Themselves*, 2000 COLUM. BUS. L. REV. 199, 199–200 (2000) (describing director entrenchment when directors appoint members of committee that votes ESOP's shares).

84. I do not mean to suggest that the interests of the participants are always monolithic. Different participants might sometimes have interests that diverge from one another; for instance, participants who are near retirement might favor policies that will enhance stock value and dividends in the short term, while those who are farther from retirement might prefer policies with greater potential payoffs that are longer-term. *See* Daniel Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105,

one example, managers might resist a takeover attempt in order to preserve their jobs, even though it might be in the participants' best interests to tender the ESOP's shares at the premium price that the would-be acquirer is offering.

It is an unsettled question to what degree ERISA's fiduciary rules apply to voting of unallocated ESOP shares. One federal court of appeals has held that ERISA fiduciary rules do not apply when a company director instructs the ESOP trustee to vote the unallocated shares in favor of the director's reelection.[85] But other cases suggest that fiduciary duties do apply in similar circumstances.[86] In any event, fiduciaries will often be able to come up with reasons why their votes were arguably in the best interests of at least some participants. The fiduciary rules might catch the most egregious betrayals, but many more will likely pass unchallenged.

D. How ESOPs Differ from Other Plans

The problem of potentially conflicted insiders and fiduciaries is not in itself unique to ESOPs. ERISA, however, rather effectively polices most of the possible conflicts that are common to both ESOPs and other plans. With respect to plan formation, ERISA limits many types of plan provisions in order to curb potential abuses. For instance, ERISA prevents employers from making workers wait years before becoming plan participants and from making participants wait an inordinately long time before their retirement benefits "vest" and become non-forfeitable.[87]

Without plan ownership of employer stock to cloud the picture, these ERISA rules render the tradeoffs for companies considering a new retirement plan quite straightforward. The company must weigh the

1120–21 (1988) (describing potential differences in interests of younger and older workers). Although Fischel and Langbein mention a number of interests that are not properly relevant because they are not interests that participants have *as participants*, the basic point that participants' interests are not always identical is sound.

85. *See* Grindstaff v. Green, 133 F.3d 416, 424–25 (6th Cir. 1998) (noting that "ERISA specifically anticipates and authorizes the 'dual role' of directors and plan fiduciaries in the ESOP context").

86. *See, e.g.*, Newton v. Van Otterloo, 756 F. Supp. 1121, 1128 (N.D. Ind. 1991) (holding that the right to vote unallocated shares in contested election of incumbent directors was subject to fiduciary rules).

87. Depending on the plan type, ERISA requires that participants be fully vested in their accrued benefits after no more than six or seven years of service. ERISA § 203(a)(2)(B), 29 U.S.C. § 1053(a)(2)(B) (2006); I.R.C. § 411(a)(2)(B) (2006). ERISA and the tax code also provide limits on such matters as age and service requirements for plan participation, benefit accrual processes, "nondiscrimination" among employees at different levels, etc. *See* ERISA §§ 202, 204, 29 U.S.C. §§ 1052, 1054; I.R.C. §§ 410(a)-(b), 411(b)-(c).

costs of each type of plan, reduced by the tax benefits, against expected advantages such as enhanced worker recruitment and retention and possible decreased demand for current compensation. Non-ESOP plans cannot borrow money, so the capital-formation temptation described above is exclusive to ESOPs.[88] Other plans that invest in employer stock incur some of the other formation-related conflicts, but to a lesser degree than ESOPs, which invest primarily in employer stock.[89]

The conflicts of interest related to buying and selling employer stock are much more acute in ESOPs than in other plans. As noted, the stock in 401(k) plans is much more likely to be publicly traded, meaning valuation issues are far less complicated.[90] Moreover, because non-ESOP plans cannot borrow money, they are generally not in a position to buy large blocks of employer stock all at once. They are, therefore, less useful to insiders, and the transaction-related conflicts are far less severe.

Likewise, the most serious share-voting conflicts that arise in ESOPs do not occur in other types of plans. Those issues spring from the gradual allocation of shares to participants' accounts in leveraged ESOPs, and other plans cannot be leveraged.[91]

E. ERISA's Central Purposes

The additional conflicts of interest arising from ESOPs are not necessary to the central purposes of ERISA: to safeguard employee benefits and to encourage employers to maintain benefit plans.[92] ERISA recognizes that certain potential conflicts—such as having plan fiduciaries who are also agents of the sponsoring employer or a participating union—are effectively unavoidable.[93] Indeed, ERISA's fiduciary rules make sense primarily as a response to the inevitable temptations that will confront fiduciaries with multiple loyalties.

That general acceptance of potential conflicts of interest, though, does not entail a tolerance for additional risks that are both avoidable and unnecessary to ERISA's purposes. Neither protecting benefits nor

88. *See supra* notes 52–54 and accompanying text.

89. *See supra* note 3.

90. *See supra* notes 64–65 and accompanying text.

91. *See supra* notes 76–86 and accompanying text.

92. *See supra* note 48 and accompanying text.

93. *See* ERISA § 408(c)(3), 29 U.S.C. § 1108(c)(3) (2006) (providing that ERISA prohibited transaction rules do not prevent fiduciary from serving "in addition to being an officer, employee, agent, or other representative of a party in interest"); *id.* § 3(14), 29 U.S.C. § 1002(14) (defining "party in interest" to include sponsoring employer and union "any of whose members are covered by" the plan).

encouraging employment-based retirement plans requires the "extra" conflicts that arise with ESOPs. Apparently recognizing this fact, ESOP advocates do not claim that ESOPs are good retirement policy.

IV. THE PRO-WORKER ARGUMENTS FOR ESOPS

A few ESOP advocates are content to argue for ESOPs primarily on the basis of their benefits for employers and company insiders.[94] Most, however, expend more energy claiming that ESOPs are good for workers. Regardless of whether they use the word "democracy," the pro-worker arguments ESOP advocates employ boil down to the idea of economic democratization. That is, they turn on the claim that ESOPs democratize the distribution of one or more economic values or goods. For some earlier ESOP advocates, the claim was systemic: ESOPs would help to reform the entire economy toward broader, more "democratic" capital ownership and wealth. For most current advocates, the idea of democratization is implicit rather than explicit, but their claims nonetheless rest on the idea of broader distribution, this time of goods such as a "sense of ownership" and control over the employer's business.

A. Yesterday: ESOPs and "Democratic Capitalism"

In most accounts of ESOP history, Louis Kelso appears as the founding father. Kelso, an economist, espoused the idea of a "democratic capitalist economy." By that term, he meant a market economy in which most people function both as "labor workers" and "capital workers," earning their living by a combination of labor and capital ownership and investment.[95] In Kelso's view, the fact that most workers earned a living solely by means of their labor and owned no capital meant that American democracy was only half of what it could and should be.[96] He believed that finding ways to get capital, in the form of stock, into workers' hands was vital to moving toward a more democratic economy in which wealth disparities would be diminished.[97]

Kelso found an ally in Senator Russell Long, who engineered the inclusion of ESOPs in ERISA in 1974.[98] Some years later, Senator Long continued to echo many of Kelso's views. He argued that ESOPs

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94. *See, e.g.*, FRISCH, *supra* note 55, at 5–11.

95. KELSO & KELSO, *supra* note 47, at 19–20.

96. *See id.* at 11–22 (discussing "Democracy's Missing Half").

97. *See id.* at 29 ("[Capital o]wnership must grow in every consumer unit to make that unit economically autonomous.").

98. *See* ROSEN ET AL., *supra* note 36, at 60–61.

addressed a "fundamental weakness" of the American economy, by giving more people "a chance to accumulate a capital estate."[99] In Long's view, ESOPs would create a fairer economy without "redistributing the wealth of current owners."[100]

For Kelso, the ESOP was one of many means to spread capital ownership to middle and working-class Americans.[101] He appears to have pursued ESOPs more actively than the other tools he proposed because ESOPs presented greater practical opportunities to implement his ideas. Having designed a number of ESOPs beginning in 1956, Kelso eventually gained the attention and support of Senator Long, which led to ESOPs' inclusion in ERISA.[102]

According to several ESOP advocates, it was mere "historical coincidence" that ESOPs made their way into ERISA, rather than some other piece of legislation: ERISA was merely the "tax train leaving the station at the time."[103] Kelso himself claimed that he introduced the first ESOP "under the *disguise* of an employee benefit plan" in order to give it the best chance of regulatory approval.[104] He even went so far as to refer to the first ESOP as "the Trojan Horse for democratizing American capitalism."[105] Kelso believed that ESOPs, together with all his other ideas for diffusing capital ownership, would transform the U.S. economy into a fully "democratic" one with less disparity of wealth.[106]

B. Today: Commitment, Satisfaction, and Productivity

Current ESOP advocates have mostly backed away from Kelso's idea that ESOPs and other forms of employee ownership have the power to redistribute wealth more evenly across the entire economy. Instead,

99. Russell B. Long, *Whose Pie? And Why ESOP's?*, CTR. FOR ECON. AND SOC. JUSTICE, http://www.cesj.org/researchtopics/long-russell/whospie-whyesop.html (last visited Aug. 22, 2009) (containing an excerpt from floor statement of Nov. 17, 1983 on "Employee Stock Ownership Act of 1983" and reprinted in Congressional Record for July 30–31 and Aug. 1, 1985).

100. *Id.*

101. *See* KELSO & KELSO, *supra* note 47, at 51–103 (describing various "financing tools for democratizing capitalism," including the ESOP, the mutual stock ownership plan (MUSOP), the consumer stock ownership plan (CSOP), the general stock ownership plan (GSOP), the individual capital ownership plan (ICOP), the commercial capital ownership plan (COMCOP), the public capital ownership plan (PUBCOP), and the residential capital ownership plan (RECOP)).

102. *See id.* at 52–53 (describing initial ESOP designed for Peninsula Newspapers in 1956 and subsequent pre-ERISA ESOPs); ROSEN ET AL., *supra* note 36, at 60–61.

103. ROSEN ET AL., *supra* note 36, at 61.

104. *See* KELSO & KELSO, *supra* note 47, at 53 (emphasis added).

105. *Id.*

106. *See id.* at 56–57 (arguing that ESOPs and other ideas would generate capital ownership for otherwise "economically underpowered consumers").

they focus on the company level, arguing that by making employees part-owners of the companies they work for, ESOPs can help to change workers' fundamental relationship with their employers and their jobs.

Workers, the argument insists, come to believe that the ESOP company is "their" company and that their good is bound up with that of the employer; as a result, they work harder to help the company do well.[107] ESOP participants, advocates say, are more likely to take "ownership" over their work and to feel satisfied in their jobs.[108] In addition, advocates claim that ESOPs encourage a more peaceful coexistence between workers and managers.[109] According to one prominent pro-ESOP book, a company with a properly-implemented ESOP can "eliminate the sense of 'us' and 'them' that pervades traditional companies."[110]

ESOP advocates further argue that workers' increased sense of ownership and commitment leads to enhanced productivity for the company.[111] The first chapter of the same pro-ESOP book is entitled, "Ownership: The Performance Additive."[112] The book's authors characterize ESOPs as "a new model of ownership and management . . . that has become a kind of hotbed for workplace innovation and that seems uniquely suited to the turbulent, topsy-turvy marketplace of the early twenty-first century."[113] ESOP advocates cite studies, most of them funded by pro-ESOP groups, for the proposition that ESOP companies outperform non-ESOP "counterparts" in sales per employee, productivity, profitability, and longevity.[114] They argue that those

107. *See* ROSEN ET AL., *supra* note 36, at 26–28; Press Release, The ESOP Association, Republican Presidential Candidate Senator John McCain Releases Statement on ESOPs (Sept. 23, 2008), http://www.esopassociation.org/media/media_McCain_pressrelease.asp (last visited Aug. 22, 2009) (quoting John McCain as saying, "Many Americans are able to 'work for themselves' through their participation in . . . ESOPs . . . .").

108. One pro-ESOP book uses the term "the equity attitude" to describe a belief among employee-owners that "[t]his is *our* company, and we will do whatever is necessary to help it succeed." ROSEN ET AL., *supra* note 36, at 26 (emphasis added).

109. *See id.* at 35 (describing ESOP companies' ability to "alter the assumptions of hierarchy" found in "conventional" businesses); Long, *supra* note 99 ("Employee ownership can also help to create a more widespread unity of interest and incentive, thereby fostering better relations between management and labor.").

110. ROSEN ET AL., *supra* note 36, at 35.

111. Long, *supra* note 99 ("[C]ompanies with employee ownership are likely to be more productive and more profitable than those without, and the more ownership held by employees, the better the performance of the company.").

112. ROSEN ET AL., *supra* note 36, at 3.

113. *Id.* at 5.

114. THE ESOP ASSOCIATION, ADVOCACY KIT 11–12 (2009), http://www.esopassociation.org/pdfs/Advocacy_Kit.pdf.

increases are likely to enhance ESOP companies' chances for long-term survival and success.[115]

Furthermore, ESOP proponents believe that ESOPs' effects on productivity and other measures directly enhance the well-being of workers. They argue that added productivity leads to better overall compensation for workers, and increased company longevity enhances job security.[116] In the words of John McCain during his 2008 campaign for the presidency, "small and entrepreneurial businesses[, which] are the lifeblood of the American economy . . . [and] are often unable to match the substantial health care and other benefits . . . provided by major corporations . . ., are able to provide employees increased retirement benefits and stable employment because of ESOPs."[117]

Like Kelso before them, today's advocates view the function of ESOPs as only incidentally including retirement planning. For example, one prominent ESOP advocate insists, on the website of a pro-ESOP organization he directs, that "ESOPs are ownership plans," rather than retirement plans.[118] According to this view, the claimed benefits of ESOPs occur without regard to their implementation as vehicles for retirement saving. Presumably, the advocates believe that ESOPs would still have the same positive effects for workers if they, and their tax benefits, fit into the statutory scheme somewhere other than in the realm of ERISA retirement benefit plans.

C. The Flaws Underlying the ESOP Advocates' Position

As noted above, even today's ESOP advocates concede that ESOPs have done nothing to change disparities in wealth among different strata

115. *See* ROSEN ET AL., *supra* note 36, at 11–12 (finding in a specific study that ESOP companies saw higher productivity levels, greater stability of employment, faster employment growth, and higher rates of survival).

116. *See* Press Release, The ESOP Association, *supra* note 107 (quoting John McCain as saying, "Research has shown that ESOP-owned companies are usually more productive and profitable than other companies, as well as having better survival rates").

117. *Id.*

118. Corey Rosen, Nat'l Ctr. for Employee Ownership, *Should ESOPs Be Subject to Stricter Diversification Rules?*, Jan. 8, 2002, http://www.esopservices.com/legislative%20updates.html#Stricter (last visited Aug. 21, 2009); *cf.* J. Michael Keeling, President, The ESOP Association, Remarks at the Conference on Employee Ownership in Grenada, Spain: Employee Ownership in the United States: Focus on the Employee Stock Ownership Plan, or ESOP, Model (June 5, 2008), *available at* http://www.esopassociation.org/about/about_esop_overview.asp (discussing retirement-based concerns with under-diversification of ESOP assets before going on to extol "the human side of U.S. ESOP companies—the story of the individuals' working in a company where they have an ownership share, and where leaders of the company care about their human environment").

within the American economy.[119] With respect to claimed increases in worker satisfaction, "labor peace," and productivity, the evidence is scarcely better. The empirical researchers most cited by ESOP advocates have found no clear connection between employee stock ownership and worker satisfaction, and one of them has concluded that ESOPs do not promote labor peace.[120] The same researchers found only a tenuous link between employee stock ownership and productivity. Summarizing other research, they found that two out of nine studies had found a positive correlation between stock ownership and productivity and none of them found a negative correlation.[121]

Other scholars have noted weaknesses even in that limited finding. For one thing, companies adopting new ESOPs often have relatively high growth rates leading up to adoption. Any post-adoption increases in productivity measures could simply be a continuation of the trend.[122]

More fundamentally, claims of increased productivity do not account for the effects of management actions that ESOP companies might adopt. Sophisticated ESOP advocates concede that an "equity attitude" among employees, which causes the alleged productivity gains, does not arise automatically because a company establishes an ESOP.[123] Instead, they admit that companies must do much more—in the way of education, information sharing, and "business disciplines" such as participatory management and incentive compensation—in order to change traditional attitudes about work and the relationship between management and workers.[124]

119. *See* JOSEPH RAPHAEL BLASI, EMPLOYEE OWNERSHIP: REVOLUTION OR RIPOFF? 114 (1988) (finding that employee-ownership law, as exemplified in ESOPs, "has reproduced the system of economic stratification in American society rather than attempting to reverse it"). I put Blasi in the general category of "ESOP advocates" because he continues to see positive possibilities for ESOPs despite his often strong critiques of ESOP law in its current form. In any event, others who are more unambiguously pro-ESOP now eschew Kelso-style claims that ESOPs can reduce wealth disparities.

120. *See id.* at 241 (concluding that present forms of employee ownership, including ESOPs, continue or even strengthen "the rigid and adversarial roles of labor and management in the large majority of cases"); Douglas Kruse & Joseph Blasi, *Employee Ownership, Employee Attitudes, and Firm Performance* 24 (Nat'l Bureau of Econ. Research, Working Paper No. 5277, 1995), *available at* http://www.nber.org/papers/w5277 (noting a split in studies regarding satisfaction and concluding that "[e]mployee ownership does not . . . automatically improve employee attitudes and behavior").

121. Kruse & Blasi, *supra* note 120, at 25. The study's authors estimated, based on "meta-analyses" of other studies, a "productivity difference" between ESOP and non-ESOP firms of 6.2%, but they cautioned, "high standard errors keep most individual estimates from being statistically significant. . . ." *Id.*

122. Benartzi et al., *supra* note 2, at 57.

123. *See* ROSEN ET AL., *supra* note 36, at 26–31 (introducing the term "equity attitude").

124. *See id.* at 95–97 (discussing such in Part III: "Building a Successful Equity-Based

Assuming that companies with ESOPs also taking these additional steps actually do experience increased productivity over companies that are comparable in other respects, it seems an obvious response to ask whether the non-ESOP changes might be producing the increases without regard to the ESOP. Claims certainly abound that various participatory management techniques can themselves lead to better productivity.[125] Even if some link to compensation is necessary in order to enhance productivity, it is by no means clear that the link must be in the form of an ESOP. Other, less risky ways of tying compensation to company or unit performance might work just as well or even better.[126] Yet ESOP advocates make no effort to disambiguate the possible causes of the productivity increases they posit.

Thus, advocates concede that ESOPs are not *sufficient* to cause increased productivity. They simply assume, without evidence, that ESOPs are *necessary* for the purported increases, in conjunction with other measures. It is at least equally plausible that any productivity increases that may occur are due to other measures that ESOP companies take, rather than the ESOPs themselves.

Finally, even if ESOPs did cause an incremental increase in productivity, that effect would still be outweighed by ESOPs' profound dangers for workers. Neither the old, "democratic capitalism" arguments nor the newer, satisfaction-and-productivity arguments for ESOPs seem sufficient to justify ESOPs in light of the problems of non-diversification and conflicts of interest described in this Article. Although promoted with arguments based on economic democratization, ESOPs have at most dubious benefits for workers, contrasted with very real disadvantages and dangers.

V. STRATEGIES FOR REFORM

So what should Congress do about ESOPs? Or should Congress leave matters as they are, trusting market forces to solve ESOPs' problems?

Company"); *id.* at 161–62 (discussing incentive compensation). Rosen and his co-authors mention such techniques as "work cells, self-managing teams . . . , open-book management . . . , [and] devolution of authority to lower levels . . . ." *Id.* at 37.

125. *See, e.g.*, Stephen M. Bainbridge, *Privately Ordered Participatory Management: An Organizational Failures Analysis*, 23 DEL. J. CORP. L. 979, 990–92 (1998) (describing "conventional wisdom" as to positive effects of participatory management on worker satisfaction, commitment, and productivity).

126. *See* ROSEN ET AL., *supra* note 36, at 161 (advocating bonuses related to performance); Hansmann, *supra* note 82, at 1811 (suggesting that a "package consisting of a well-diversified pension fund and a profit-sharing compensation plan" would be preferable to an ESOP).

A. Self-Regulation by Labor Markets

Perhaps labor markets can take account of ESOPs' defects and resolve matters satisfactorily. On this view, employers with "bad" retirement plans, such as ESOPs, will either be forced to improve other areas of compensation or lose high-quality workers, thereby suffering a competitive disadvantage vis-à-vis their non-ESOP competitors. If these market mechanisms work efficiently, it might be acceptable for Congress to leave the law as it is.

The assumption, though, is a large one. It requires that workers be generally able and willing to switch employers due to perceived differences in retirement plan risks. It also demands that workers understand and correctly value such risks and their implications for the workers' future. A general discussion of mobility within labor markets is beyond the scope of this Article, but there is a good deal of evidence that workers—and, for that matter, many employers—do not comprehend the risks of investing retirement funds in employer stock.

In the 401(k) context, scholars have noted that workers are prone to underestimating the likelihood that their employer will go bankrupt, or even that the employer's stock will do anything but continually increase in value.[127] Nor do workers or employers understand the long-term negative effects of under-diversification on the value of retirement savings.[128] Any appeal to labor markets to blunt the ill effects of ESOPs runs contrary to these realities. Workers cannot efficiently abandon employers with bad retirement plans or demand adequate substitute compensation if they are not aware of what makes a plan risky or how to measure the dangers accurately.

Moreover, the notion that the market will solve the problem seems odd, given that retirement plans exist in a zone of pervasive regulation and government incentives.[129] Congress encourages retirement plans generally, and ESOPs in particular, making it very difficult to identify a meaningful baseline "market."

127. *See* Benartzi et al., *supra* note 2, at 56 (noting a survey finding that six of ten employees believe their company's stock is either safer or no riskier than a diversified fund with many stocks); Stabile, *supra* note 2, at 547–52.

128. *See* Benartzi et al., *supra* note 2, at 53–56, 62–63 (discussing the costs to employees and employers regarding the risk of company stock).

129. In addition to ERISA and substantial portions of the Internal Revenue Code, retirement plans are also subject to voluminous regulations promulgated by the Department of Labor and the Department of Treasury.

B. Diversification and Disclosure Requirements

One possible regulatory approach to ESOPs might be the one Congress adopted with respect to 401(k) plans in the aftermath of the Enron debacle. Even though many in academia and elsewhere called for Congress to limit or proscribe 401(k) plans' ownership of employer stock,[130] Congress chose the far more limited course of setting enhanced diversification requirements and disclosure rules. Participants in 401(k)-type plans now have a statutory right to diversify immediately their own contributions to the plan and, after three years of service with the employer, they have the right to diversify employer contributions as well.[131] In addition, plans must provide participants with information regarding their diversification rights and the importance of diversified retirement investing.[132]

From the perspective of plan administrators and company insiders, such requirements in the ESOP context would represent a serious imposition. In privately-owned companies, where some 97 percent of ESOPs reside, the company has to buy back the ESOP shares of participants who "cash out" through retirement or diversification.[133] If participants actually took advantage of enhanced diversification requirements, companies would face less predictable buy-back responsibilities.[134] Companies and insiders might also lose some of the benefits of ESOPs described above in Part IV if participants took advantage of new diversification opportunities and significantly reduced the amount of employer stock held in ESOPs.

In any event, the diversification and disclosure route would not fully resolve the problem of under-diversification, especially for leveraged ESOPs, and it would therefore leave much of ESOP participants' savings unnecessarily vulnerable. A significant majority of ESOPs are of the leveraged variety. In a leveraged ESOP transaction, the shares of stock that the ESOP buys stand as security for the loan of the purchase money.[135] The shares remain in a suspense account and are released

130. *See, e.g.*, Kaplan, *supra* note 2, at 77–81 (advocating a complete ban on all 401(k) investment in employer stock); Stabile, *supra* note 2, at 557–58 (describing legislation introduced, but later withdrawn, by Senators John Corzine and Barbara Boxer that would have imposed a 20 percent cap on employer stock in 401(k) plans).

131. *See supra* note 44 and accompanying text.

132. *See supra* note 44 and accompanying text.

133. *See* I.R.C. § 409(h) (2006) (governing a participant's "right to require that the employer repurchase employer securities under a fair valuation formula").

134. *See* Rosen, *supra* note 118, at 2.

135. *See* 29 C.F.R. § 2550.408b-3(e) (2009) (outlining the liability and collateral of ESOP for loan).

and allocated to participants' accounts only in proportion to the amount of the loan's principal and interest the ESOP has repaid.[136] It does not seem workable to suggest that participants could diversify their ESOP holdings by selling company shares that are still necessary as security for the ESOP's lenders. Accordingly, any enhanced diversification requirement would only affect the shares that have been allocated to participants' accounts.[137] In leveraged ESOPs, therefore, such requirements would have very little effect for years after the leveraged transaction.

Even in non-leveraged ESOPs, diversification requirements are unlikely to solve the under-diversification problem. As noted, workers often do not understand the implications of non-diversified retirement investing.[138] That tendency persists despite attempts to educate workers about the risks involved.[139] Scholars have begun to trace the psychological phenomena that might explain workers' "irrational" investment decisions in the 401(k) context,[140] and there is no reason to think that the tendencies are any less pronounced among ESOP participants.

In any event, it seems a strange solution to require ESOPs to allow and encourage their participants to invest in assets other than employer stock. ESOPs are, after all, specifically designed to invest in employer stock. If, against the odds, diversification requirements were successful in achieving significant diversification, then they would to that same extent spell the end of ESOPs as they currently exist. If we want to get rid of ESOPs, it is at least arguable that we should do it more directly.[141]

C. Requiring "Companion" Plans

Another idea is that having workers participate in additional, non-ESOP retirement plans might offset the dangers of ESOPs. On this theory, Congress could require any employer that sponsors an ESOP to

136. *See* 26 C.F.R. §§ 54.4975-7, 54.4975-11 (discussing release from encumbrance and allocation to participants' accounts); 29 C.F.R. § 2550.408b-3(h) (discussing release from encumbrance).

137. *Cf.* I.R.C. § 401(a)(28) (applying existing, limited diversification requirements for ESOPs to specified portions "of the participant's account in the plan").

138. *See supra* notes 127–128 and accompanying text.

139. *See* Stabile, *supra* note 2, at 552–55 (citing evidence that improved disclosure and education do little to improve investment allocation decisions and noting even lower likelihood of improvement with respect to investment in employer stock).

140. *See id.* at 547–52 (describing behavioral theory explanations for employees' choices to invest heavily in employer stock).

141. *See infra* notes 151–56 and accompanying text.

sponsor another retirement plan as well, either a fully-diversified 401(k) or other defined contribution plan, or a traditional, defined benefit pension plan.[142] In the course of critiquing 401(k) plans for placing many of the risks and responsibilities of retirement saving on workers, Richard Kaplan has suggested that employers should have to pair their 401(k) plans with another type of defined benefit or defined contribution plan.[143] In the ESOP context, such a requirement would at least mean that workers would not have their retirement savings invested *solely* in employer stock.

But merely requiring employers to maintain an additional plan could not be the sole feature of this idea; it would have to be only the beginning. Such a scheme would also have to regulate how employers could divide contributions between the plans; otherwise, an employer could simply design the companion plan to receive very little money and funnel nearly all the contributions to the ESOP instead. If Congress required both that ESOP companies maintain a diversified plan and that they observe an even division of contributions between that plan and the ESOP, workers would still begin with half their retirement savings invested in employer stock. But even ESOP advocates agree that such a percentage is far too high.[144] Depending on the performance of the employer's stock compared to the other plan's portfolio, that concentration might increase further over time.

If the idea of requiring a companion plan were to have a chance of truly addressing the problem of under-diversification, Congress would have to go beyond even a flat mandate of contribution levels. It would have to set the initial balance of contributions so that each participant had no more than a given percentage of his or her total plan assets in the ESOP. Then, Congress would need to require that the employer adjust future contribution levels to maintain each participant's ESOP balance below that ceiling, taking into account changes due to investment performance.

Thus conceived, the companion-plan requirement would entail a fantastic degree of regulatory oversight. In any event, like the diversification-plus-disclosure idea discussed above, it would essentially amount to a roundabout way of writing ESOPs out of ERISA and the tax code entirely. Requiring paired plans with a ceiling on each participant's ESOP balance relative to the companion plan is

142. *See supra* note 40 (explaining "defined contribution" and "defined benefit" plans).

143. Kaplan, *supra* note 2, at 69–70.

144. ROSEN ET AL., *supra* note 36, at 15 (acknowledging that having more than 20 percent of one's retirement savings in company stock is "probably too much concentration").

functionally the same as maintaining a single plan with a cap on the amount any worker can invest in employer stock. Because of the onerous regulatory implications, this idea would likely be no easier to enact than an outright ban on ESOPs.

D. Solutions Addressing ESOPs' Conflicts of Interest

One might imagine a different set of possible reforms aimed at addressing some of the conflict-of-interest issues identified in Part III. Specifically, different approaches might seek to address conflicts relating to ESOP adoption, ESOP transactions, and voting of ESOP shares.

1. Worker Voting on ESOP Adoption

With respect to ESOP formation, Congress might require companies to let workers vote on whether to adopt an ESOP.[145] But as we have already seen, many workers do not fully understand, or do not rationally react to, the risks inherent in investing retirement assets in employer stock.[146] Even if the worker-approval idea incorporated mandatory education, it would still be unlikely to redress the current imbalance of power in favor of insiders.[147]

2. Participant Control Over ESOP Transactions

Congress could try to redress transaction-related conflicts of interest by requiring participant approval for share purchases and for sales outside the normal course of retirement.[148] It could also mandate participant involvement, or even control, over the hiring and retention of independent fiduciaries and valuation experts.[149]

The first option runs into the same difficulties as the other worker-approval proposals discussed above. In addition, participants would have little information available in deciding whether to approve a share transaction aside from the opinions of the fiduciary and the valuation expert. Therefore, the second option—giving workers control over the hiring and firing of those service providers—holds more promise. Over time, participant control over those decisions might make fiduciaries

145. Ezra S. Field, Note, *Money for Nothing and Leverage for Free: The Politics and History of the Leveraged ESOP Tax Subsidy*, 97 COLUM. L. REV. 740, 783–84 (1997).

146. *See supra* notes 127–128 and accompanying text.

147. *See supra* note 139 and accompanying text.

148. *Cf. supra* note 133 and accompanying text (describing an ESOP company's obligation to buy back participants' shares at retirement).

149. *See generally supra* Part III.B and accompanying notes (discussing conflicts of interest in hiring of ESOP fiduciaries and valuation experts under current ERISA legislation).

and valuation firms more protective of participants' interests and less solicitous of management.

Transaction decisions, however, are only a subsidiary part of the ESOP problem. Even if Congress could reform the process governing such decisions, it would leave unaddressed the grave problems of non-diversification. It would also beg the question whether implementing an ESOP can ever be a good idea for workers.

3. Voting Reforms

Similarly, reforms to the voting rules for ESOP stock could afford workers some protection against specific conflicts of interest, but they would not address the other fundamental issues with respect to ESOPs. Congress could, for instance, require pass-through voting on all matters and constrain ESOP trustees to vote unallocated shares in proportion to the participants' voting of their allocated shares.[150] This proposal, however, does not account for information asymmetries between workers and managers or for the likelihood that some workers will forgo voting entirely due to the small number of shares each can control. More fundamentally, these ideas would not address non-diversification or the deep conflicts surrounding ESOP formation.

E. Elimination of ESOPs

A more direct approach would be to do away with the ESOP as a separate form of retirement plan. Congress could repeal all exceptions and incentives for ESOPs, leaving the law as it stands with respect to employer stock in 401(k)-type plans. The benefit of such an approach would be to eliminate the leveraged ESOP and all the particular ills that flow from it. This approach would also repeal the ESOP-specific tax benefits for selling shareholders and others.[151]

The major shortcoming of the ESOP ban is that it would leave the current rules in place with respect to 401(k)-type plans' investments in employer stock. As others have pointed out, the post-Enron disclosure-and-diversification rules are insufficient to redress the non-diversification dangers of such investments.[152] Still, doing away with ESOPs as a separate form of plan would be a great stride forward.

150. *See* McDonnell, *supra* note 83, at 259.

151. *See supra* note 47 and accompanying text.

152. *See* Benartzi et al., *supra* note 2, at 67 (attributing employees' failure to diversify portfolios to inertia effects); Stabile, *supra* note 2, at 553–55 (discussing other pressures—such as company loyalty, employer-matched contributions, and optimistic biases—counteracting employee diversification education).

F. Cap or Prohibition on Plan Investment in Employer Stock

Finally, the most sweeping reforms would consist of capping the amount of employer stock any participant could have in her defined contribution plans, perhaps at the 10 percent level currently applicable to defined benefit plans,[153] or banning all retirement plan investment in employer stock. A cap would involve significant compliance expenses, due to the need to recalculate each participant's proportion of employer stock as prices fluctuate.[154] It would, however, allow employees to hold stock in their employer and obtain the tax advantages attendant upon retirement plans, but without incurring an inordinate risk from non-diversification.[155]

Ultimately, banning all employer stock in retirement plans is the most direct solution, and probably the best. It would protect workers from all the dangers peculiar to ESOPs, and, after a transition period, it would involve relatively few compliance costs.

G. The Political Reality Regarding Proposed Solutions

If the post-Enron experience with 401(k) reform is any measure, none of the proposed reforms is particularly likely to pass Congress.[156] ESOP trade groups, which represent ESOP companies and service providers such as institutional fiduciaries and valuation companies, would vigorously resist reform.[157] As Senator McCain's pro-ESOP statement suggests, some members of Congress take the position that ESOPs are good for workers.[158] Moreover, the more sweeping reforms, such as limiting or prohibiting investment in employer stock by 401(k) plans as well as ESOPs, run up against the idea that workers should be

153. *See* ERISA § 407(a)(2), 29 U.S.C. § 1107(a)(2) (2006) ("A plan may not acquire any qualifying employer security or qualifying employer real property, if immediately after such acquisition the aggregate fair market value of employer securities and employer real property held by the plan exceeds 10 percent of the fair market value of the assets of the plan.").

154. *See* Kaplan, *supra* note 2, at 78 (noting that caps "require constant monitoring as the market value of the plan's various securities fluctuate").

155. *See* WILLIAM E. EVEN & DAVID MACPHERSON, DEP'T OF LABOR, EMPLOYEE BENEFITS SEC. ADMIN., THE CAUSES AND CONSEQUENCES OF PENSION FUND HOLDINGS OF EMPLOYER STOCK 38 (2004), *available at* http://www.dol.gov/ebsa/pdf/EvenMacpherson0404.pdf (projecting that a 10 percent cap on employer stock in all pension plans, including ESOPs, would reduce rate of return by less than one-half a percentage point but would reduce standard deviation of returns by approximately 50 percent, assuming employer stock was replaced by investment in value-weighted market composite index).

156. *See* Stabile, *supra* note 2, at 557–58 ("[N]either a percentage limit nor a provision discouraging matching contributions in employer stock was politically viable.").

157. *See* Kaplan, *supra* note 2, at 79 (describing employers' resistance to 401(k) reforms after Enron).

158. *See supra* notes 107, 116 and accompanying text.

allowed to choose their own investments, even if they choose unwisely.[159]

It is at least possible, though, that the corporate failures and stock market declines of 2008 and 2009 might improve the legislative climate for ESOP-related reforms. High-profile bankruptcies in ESOP companies highlight the severe risk ESOPs place on workers.[160] Recent episodes involving banking and other high-profile sectors might have enhanced Congress' suspicion of conflicts of interest in the corporate milieu. Perhaps members of Congress could be made to understand the damage that non-diversification does to participants' retirement savings, and the dangers of unnecessary conflicts of interest that ESOPs entail.

VI. A WORD ABOUT POSSIBLE IMPLICATIONS

One might ask, why limit the critique posed in this Article to ESOPs and employer stock, or even to retirement plans? People make all sorts of under-diversified investments and other decisions with seemingly poor risk characteristics. Entrepreneurs gamble their families' nest eggs on new business ventures, for instance, even though their savings would, on average, be better invested in a diversified portfolio.

The premise behind the entire enterprise of ERISA and relevant parts of the tax code is that retirement savings occupy a special place in the national economy. In simplistic terms, those statutory rules, along with such mechanisms as Social Security and Medicare, reflect a judgment that dire poverty among the elderly is not tolerable. On that idea, we have built a superstructure of tax advantages and regulations regarding private retirement plans.

It is beyond the scope of this Article to peer beneath that foundational premise. Given a system of incentives and regulations, the question becomes how best to adjust those devices to achieve the stated goals. The conclusion that we should not allow extreme under-diversification in tax-advantaged retirement savings, then, does not necessarily imply that the same should be true beyond that realm. There might or might not be good reasons to regulate individuals' poor or "irrational" investment choices in other contexts, but such reasons are not part of this Article.[161]

159. *See, e.g.*, Kaplan, *supra* note 2, at 80–81 (criticizing the "participant choice" argument).

160. *See supra* notes 9–17 and accompanying text.

161. The same is true, albeit for different reasons, of implications for other examples of bad decision making with respect to retirement investing. For instance, workers who direct their own investments in defined contribution plans often choose levels of equity investment that are suboptimal for the workers' retirement needs—such as investing too lightly in equities when far from retirement or too heavily when close to retirement. It is certainly plausible that regulatory

VII. CONCLUSION

ESOP advocates promote ESOPs as being good for workers, as desirable instruments of economic democratization. In reality, however, ESOPs expose workers to dramatic, uncompensated investment risks in comparison to diversified retirement plans. In addition, ESOPs heighten the temptations and opportunities for insiders to prefer their own interests, and those of the company, over the best interests of the worker-participants.

Congress should address these problems by prohibiting retirement plan investment in employer stock. Failing that, Congress should, at a minimum, repeal the exceptions and incentives that allow ESOPs to exist as tax-advantaged retirement plans.

changes might be an appropriate response to such errors, but it is not self-evident based on the limited conclusions regarding ESOPs in this Article. Government control over retirement investments beyond the relatively small subset of employer stock might have unintended effects on capital markets, and there are likely other considerations that would merit separate analysis.