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Employee Stock Ownership Plans: A Solution or a Hindrance to the Search for a Representative and Productive Style of Employee Ownership?

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EMPLOYEE STOCK OWNERSHIP PLANS: A SOLUTION OR A HINDRANCE TO THE
SEARCH FOR A REPRESENTATIVE AND PRODUCTIVE STYLE OF EMPLOYEE
OWNERSHIP?

I. INTRODUCTION	131
II. A PERSPECTIVE	132
A. <i>Fundamental Characteristics of the ESOP</i>	133
B. <i>The Leveraged ESOP</i>	134
C. <i>Employee Qualifications/Mechanics of ESOP Administration</i>	135
III. ESOPS AND THE ROLE OF THE COURTS	136
A. <i>ESOPS and the Status of Employee Owners: To Whom Does the Fiduciary Duty Extend?</i>	137
IV. THE CONTROL QUESTION	145
V. ESOPS AND WORKER PARTICIPATION: A PRODUCTIVE COMBINATION	147
VI. CONCLUSION	149

I. INTRODUCTION

Over the years, there has been a movement toward achieving democratic reform in the work-place. In an effort to improve employment relations¹ and to stimulate increased worker productivity,² companies have been encouraged to provide employees with a stronger voice in management through the use of ownership plans. This movement, however, faces obstacles. Specifically, there is an inherent tension between providing employees with a degree of ownership to the extent that its effects will be financially beneficial, and management's desire to maintain control. Of the various forms of existing employee ownership, the employee stock ownership plan ("ESOP") is the most common.³ In 1974, roughly 300 companies had ESOPs.⁴ As of June 1990, the figure was closer to 10,000.⁵ In approximately 1,000 of those companies featuring ESOPs, the employees owned a majority of the stock.⁶

1. Cf. Dugger, *Democratic Economic Planning and Worker Ownership*, 21 J. Econ. Issues 87, 90 (1987).

2. See *Id.* at 91.

3. COREY ROSEN ET AL, *EMPLOYEE OWNERSHIP IN AMERICA: THE EQUITY SOLUTION* 17 (1986).

4. *Id.* at 15.

5. Henrey Hansmann, *When Does Worker Ownership Work? ESOP's, Law Firms, Codetermination, and Economic Democracy*, 99 YALE L.J. 1749, 1752 (1990).

6. *Id.*

Nevertheless, the use of the ESOP in modern business remains controversial. Some argue that it is not a form of real ownership, and contend that it benefits the corporation to a greater extent than it does the employee.⁷ Congress's attempt to encourage employee ownership through the creation of ESOPs - with the expectation that employees would have a greater overall investment in their companies, thereby resulting in increased productivity, has been criticized. The critics argue that the program has somewhat backfired by lining "the pockets of management, banks and investment bankers."⁸ Others maintain that employees have little or no control making an ESOP company merely "an investor-owned firm with incentive compensation schemes."⁹ Despite these criticisms, ESOPs have grown tremendously since their formal inception in the 1970's. Today, approximately ten million employees, (roughly twenty-five percent of all corporate workers) are covered by ESOPs.¹⁰

This Comment explores the use and effects of the ESOP in modern business practices. Section II discusses the historical origins and characteristics of ESOPs. Section III addresses the necessity of implementing and executing a fair and just ownership plan, and the various steps courts have taken to ensure such a result. This section also explores the existing tension between the duty owed to the corporation and its shareholders and the duty owed to ESOP shareholders. Section IV analyzes the issue of employee control. Section V reviews the overall productivity of ESOPs, focusing on specific business entities with successful ownership plans. Finally, in Section VI, this Comment concludes that by using ESOPs wisely, employee productivity will rise and the business entity will flourish, while at the same time serving the underlying policy of promoting workplace democracy.

II. A PERSPECTIVE

Although the concept surrounding the viability of employee stock ownership is not recent,¹¹ the ESOP became prominent only

7. See Susan Dentzer Et Al. *The Foibles of ESOP's: Employee Stock Plans Haven't Proved the Perfection of Capitalism*, NEWSWEEK, Oct. 19, 1987, at 59.

8. *Id.* at 58.

9. Hansmann, *supra* note 6, at 1757. The article states that "rarely are [ESOPs] structured to give the workers a significant voice in the governance of the firm." *Id.* at 1797.

10. Dentzer Et Al., *supra* note 7, at 50.

11. A brief historical recounting traces the concept of the ESOP to the 1950's and investment banker Louis Kelso. He maintained that a system where workers could automatically become owners and would establish a stronger foundation for the capitalist system. Calling the system the ESOP, he sought to convince companies that this plan would be ideal, since it would increase productivity as well as provide effective tax breaks for the companies. While his idea received some acceptance, many worried the courts would not allow the tax benefits. Kelso decided to approach Senator Russell Long, who at that time

after Congress's adoption of the Employee Retirement Income Security Act of 1974.¹² Also known as ERISA, it is an incentive program designed to provide the employee with an opportunity to acquire stock in its employer company without having the burden of investing substantial amounts of money.¹³ Congress saw this as a means of increasing employee wealth, productivity, and morale, while simultaneously providing significant tax benefits to firms implementing the program.¹⁴ The tax benefits were designed to provide employer companies with an economic incentive to create ESOPs.¹⁵ Additional tax laws, such as the 1984 Deficit Reduction Act and the 1986 Tax Reform Act, are also considered responsible for the vast increase in the number of ESOPs.¹⁶

A. Fundamental Characteristics of the ESOP

An ESOP is organized as a trust, with the purpose of either providing shares of the company's own stock or contributing dollars in order to purchase shares of stock from existing owners.¹⁷ *Donovan v. Cunningham*¹⁸ provides a general description of the mechanics of an ESOP as established by ERISA:

An ESOP is a form of employee benefit plan designed to invest primarily in securities by its sponsoring company. . . . An employer desiring to set up an ESOP will execute a written document to define the terms of the plan and the rights of beneficiaries under it. The plan document must provide for one or more named fiduciaries to control and manage the operation and administration of the plan. A trust will be established to hold the assets of the ESOP. The employer may then make tax-deductible contributions to the plan in the form of its own stock or cash. If cash is contributed, the ESOP then purchases stock in the sponsoring company, either from the company itself or from existing shareholders.¹⁹

was considered one of the most influential members of Congress. Long not only saw to it that the ESOPs were afforded the tax incentives suggested by Kelso, but also provided a few more. *COREY ROSEN ET AL.*, *supra* note 4, at 14-15. Senator Long was instrumental in the initiation of over twenty bills for the creation of ESOPs. Ungeheuer, *infra* note 26, at 51.

12. Employee Retirement Income Security Act, 29 U.S.C. §§ 1101-1461 (1988).

13. Alan Hyde & Craig Livingston, *Employee Takeovers*, 41 *RUTGERS L. REV.* 1131, 1139 (1989).

14. For a discussion of ESOP tax benefits, see *supra* note 13, at 1141-45.

15. *Id.* at 1140.

16. Julie Kaufman, *Democratic ESOPs: Can Workers Control Their Future?*, 5 *LAB. LAW.* 825, 826 (1989).

17. *ROSEN ET AL.*, *supra* note 3, at 17.

18. 716 F.2d 1455 (1983).

19. *Id.* at 1458-59 (citations omitted).

B. *The Leveraged ESOP*

Alternatively, and in this respect ESOPs differ from other benefit plans under ERISA, the ESOP trust may borrow money in order to invest in the company stock.²⁰ This is what is known as a leveraged ESOP.²¹ In a leveraged ESOP, the trust is financed by an outside lender such as a commercial bank or a savings and loan.²² Instead of giving the loan dollars to the corporation itself, the lender directs the proceeds to the trust fund, which in turn gives the lender a note for the loan amount.²³ The corporation becomes the guarantor of the loan, by promising to make periodic payments into the trust to ensure that the debt is properly amortized.²⁴

The growth rate of leveraged ESOPs has been significant: during the first half of 1989 ESOP borrowing was over \$24 billion.²⁵ Despite its recent success, the leveraged ESOP is not without detractors. Even economist Louis Kelso, the individual responsible for the ESOP concept, commented: "That is a perversion of my idea . . . [i]nstead of making economic power more democratic, they make it more plutocratic."²⁶

The emergence of the leveraged ESOP has spawned situations in which device has proven instrumental in leveraged buyouts by workers²⁷ and as a tool for corporate management to avert hostile takeover attempts.²⁸ Contrary to popular belief, the implementation of ESOPs by workers in failing companies is not the norm.²⁹ In fact, ESOPs are utilized for worker buyouts of failing

20. *Id.* at 1459.

21. *First Nat'l Bank of Blue Island v. Board. of Governors*, 802 F.2d 291, 293 (7th Cir. 1986).

22. LOUIS KELSO & PATRICIA KELSO, *DEMOCRACY AND ECONOMIC POWER: EXTENDING THE ESOP REVOLUTION* 60 (1986).

23. *Id.* at 61.

24. *Id.*

25. NATIONAL CENTER FOR EMPLOYEE OWNERSHIP, *THE EMPLOYEE OWNERSHIP READER 5* (1983) [hereinafter *READER*]. The *READER*, revised annually, is a publication of the National Center for Employee Ownership (NCEO), a non-profit research and membership organization in Oakland, California. The *READER* is available from the NCEO for a fee.

26. Frederick Ungeheuer, *They Own the Place: Employee-Stock Plans Come of Age as Morale Boosters and Takeover Tools*, *TIME*, Feb. 6, 1989, at 51.

27. See Hyde & Livingston, *supra* note 13, at 1131-93.

28. For a discussion of this issue, see McLean, *Employee Stock Ownership Plans and Corporate Takeovers: Restraints on the Use of ESOPs by Corporate Officers and Directors to Avert Hostile Takeovers*, 10 *PEPP. L. REV.* 731 (1983).

29. Corey Rosen, *The Growing Appeal of the Leveraged ESOP*, *J. BUS. STRATEGY*, Jan./Feb. 1989, at 17.

companies in approximately 1 percent of the cases.³⁰ Additionally, in only 1 percent of the cases are ESOPs established in which employees must accept wage concessions for a minority interest in the firm.³¹ It is estimated that about 98 percent of ESOPs are created in healthy, productive companies.³²

C. Employee Qualifications/Mechanics of ESOP Administration

The shares of stock in an ESOP are apportioned among the employees through individual accounts.³³ The number of shares in each account is determined on the basis of an individual's salary, seniority, or some other method of calculation.³⁴ The employee's right to acquire stock in her account will broaden as she achieves increasing seniority, and this right will continue until she becomes fully vested following a certain tenure.³⁵ The employee has the right to remove the stock from the trust account when she either leaves the company or retires.³⁶ If the employee leaves the company at any time prior to becoming fully vested, she may withdraw the percentage of what she is entitled to receive in her account. The remaining shares of stock that are not vested are returned to the trust for reapportionment.³⁷ Typically, the employee sells the shares of acquired stock back to the corporation.³⁸ However, in the case of a public corporation, she may freely sell the shares on the open market.³⁹

ESOPs are administered by a trustee, typically appointed by management. The trustee can be from within the corporation,⁴⁰ or outside the realm of the corporation's management, *i.e.*, a bank trust department.⁴¹ Certain ESOPs provide broad voting power, allowing employees to vote their stock on all matters (for instance, in public companies), while others restrict the voting

30. Corey Rosen & Alan Cohen, *Employees to the Rescue: The Record of Worker Buyouts*, 6 J.L. & Com. 213, 214 (1986).

31. *Id.*

32. Rosen, *supra* note 29, at 17.

33. *Id.*

34. ROSEN ET AL., *supra* note 3, at 17-18.

35. *Id.* at 18.

36. *Id.*

37. *Id.*

38. *Id.*

39. See READER, *supra* note 25, at 37.

40. "ERISA clearly provides that a fiduciary may be an officer or employee of the company whose securities he purchases on behalf of a plan. 29 U.S.C. 1108(c)(3)." *Donovan v. Cunningham*, 716 F.2d 1455, 1466 (5th Cir. 1983).

41. See READER, *supra* note 25, at 7. Many experts in the field of ESOPs recommend that it is preferable to appoint such independent trustees. *Id.*

power to certain limited issues.⁴² Though there are instances where employee participation in ESOPs is contingent upon wage reductions,⁴³ most ESOPs do not require employee concessions.⁴⁴

ESOPs, being complex mechanisms, are heavily regulated to ensure that the plans are utilized for legitimate corporate purposes and in the best interests of the beneficiaries of the trust. Such valid corporate purposes include improving employee morale and loyalty,⁴⁵ raising capital for the business,⁴⁶ and supplementing employee compensation or retirement benefits.⁴⁷ ESOPs may be created with some degree of flexibility in order to accommodate overall corporate objectives, as when a company adopts several ESOPs, with each trust representing a specific employee group.⁴⁸

III. ESOPs AND THE ROLE OF THE COURTS

While the analysis has focuses on the types of ESOPs and the underlying purposes for their adoption, the question still remains regarding the role of the courts, as well as the measures they have taken to guarantee that the trusts are fairly administered and implemented in the primary interest of the employee. This section explores the steps courts have taken to ensure that ESOPs are not abused by management, but rather are adopted for their intended purpose.

Many of the ESOP cases involve allegations that plan administrators breached their fiduciary duties to plan participants as promulgated by ERISA, which defines these duties as follows:

A fiduciary shall discharge his duties with respect to a plan solely in the interests of the participants and beneficiaries . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character

42. ROSEN, *supra* note 3, at 16-17.

43. See *Childers v. Northwest Airlines, Inc.*, 688 F. Supp. 1357, 1359 (D.Minn. 1988) (employees participated in an ESOP following an agreement to a 15% wage reduction).

44. See READER, *supra* note 25, at 22.

45. *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 266 (2d Cir. 1984).

46. *Id.* See also *Childers*, 688 F. Supp. at 1359 (ESOP was established in order to improve the company's financial position).

47. See *Norlin*, 744 F.2d at 266.

48. See *Childers*, 688 F. Supp. at 1359 (the company adopted four ESOPs, three representing each union and one for salaried employees).

with like aims⁴⁹

In essence, this section imposes on ESOP plan fiduciaries both the duty of loyalty and the duty of care.⁵⁰ In order to encourage the use of ESOPs, courts, which construe these duties very strictly, acknowledge the need to balance these standards with the large degree of legislation Congress has passed.⁵¹ In addition, plan administrators have a duty to disclose certain information to the employees.⁵² Plan participants are also afforded remedies for such breaches of fiduciary duty including "removal of the fiduciary, rescission of unlawful transactions, and recovery of monetary loss to the plan."⁵³

A. *ESOPs and the Status of Employee Owners: To Whom Does the Fiduciary Duty Extend?*

Recent ESOP cases involve the use of ESOPs as a means to avert hostile takeovers. In this context, the target companies create the ESOP knowing that the adoption of the trusts would entail a large amount of debt,⁵⁴ presumably making the company an unattractive takeover target. At first glance it appears that in designing an ESOP for a company, the fact that it was used to thwart a takeover does not necessarily render the plan illegitimate as long as it was established in the best interests of the employees. However, it seems that the primary concern of the courts in these instances is that the ESOP be implemented with the express purpose of employee benefit, rather than as a means to maintain control of the firm and further entrench management.

Fairness to the employee participants is not the sole reason behind permitting the ESOP to stand, rendering this issue

49. 29 U.S.C. § 1104(a) (1988).

50. See *Donovan v. Cunningham*, 716 F.2d 1455, 1464 (5th Cir. 1983). The opinion states: "The legislative history of ERISA indicates that Congress intended to incorporate . . . the 'core principles of fiduciary conduct' that were developed in the common law of trusts, but with modifications appropriate for employee benefit plans." *Id.*

51. "Competing with Congress' expressed policy to foster the formation of ESOPs is the policy expressed in equally forceful terms in ERISA: that of safeguarding the interests of participants in employee benefit plans by vigorously enforcing standards of fiduciary responsibility." *Id.* at 1466.

52. Such information includes "a summary plan description; an annual statement of the plan's assets, liabilities, receipts, and disbursements; and, upon request, a statement of a participant's or beneficiary's total accrued benefits and total accrued nonforfeitable pension benefits." 29 U.S.C. §§ 1021-1025. *Childers*, 688 F. Supp. at 1361.

53. See *McLean*, *supra* note 28, at 764.

54. "A leveraged buy-out is . . . a business practice wherein a company is sold . . . under financial arrangements in which there is a minimum amount of equity and a maximum amount of debt." *United States v. Tabor Ct. Realty Corp.*, 803 F.2d 1288, 1292 (3d Cir. 1986).

particularly sensitive. In many of these cases, the administrators of the ESOP are the directors of the corporation. Hence, there exists a great tension between the fiduciary duty of trustees to plan participants on the one hand, and the fiduciary duty towards the corporation and its shareholders on the other. The following cases are analyzed because they represent similar analyses of ESOPs in the context of a corporate takeover; with the difference being that the court upheld an ESOP creation in one instance, yet disallowed it in another. Analysis indicates that the courts will allow the ESOPs if they find that adoption does not contravene the duties owed to the corporation and its shareholders.

*Norlin Corp. v. Rooney, Pace, Inc.*⁵⁵ illustrates the ineffectiveness of establishing an ESOP in the face of a hostile takeover. Norlin, the target of a hostile takeover attempt, established an ESOP. Norlin organized the trust to ensure its voting control of the newly issued stock, presumably in order to defend itself from moves made against the company.⁵⁶ One of its directors wrote to the shareholders indicating that the corporation had established the ESOP, but provided no reason for the action other than the avoidance of hostile takeover attempts.⁵⁷ The raider brought suit against Norlin asserting that the transfers of stock violated federal securities laws, and that there was no valid business purpose for the stock transfers in that the transfers were performed for the express purpose of entrenching management.⁵⁸

In its analysis, the court decided to adopt the fiduciary principles standard to determine the viability of the ESOP.⁵⁹ In determining that the ESOP was not a proper exercise of authority by the board of directors, the court first explored the "business judgment rule"⁶⁰ which is used to determine compliance with the duty of care.⁶¹ The court indicated that the business judgment rule governs "only where the directors are not shown to have a self-interest in the transaction at issue,"⁶² in which case it "bars judicial inquiry into actions of corporate directors taken in good faith and in exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes."⁶³ By applying these

55. 744 F.2d 255 (2d Cir. 1984).

56. *Id.* at 258.

57. *Id.* at 259.

58. *Id.* at 260.

59. *Id.* at 264.

60. *Id.*

61. The court defined the duty of care as the "responsibility of a corporate fiduciary to exercise, in the performance of his tasks, the care that a reasonably prudent person in a similar position would use under similar circumstances." *Id.* at 264.

62. *Id.* at 265.

63. *Id.* at 264 (citing *Auerbach v. Bennett*, 47 N.Y.2d 619, 629 (1979)).

principles, the court found that the target company's transfer of stock to the ESOP,⁶⁴ solely to avert a takeover, violated Norlin's fiduciary duty owed to its shareholders.⁶⁵ This was held despite the target company's contention that the creation of an ESOP was an appropriate anti-takeover measure.⁶⁶

The court applied a number of factors in reaching its conclusion. The first factor considered was timing.⁶⁷ The court noted that the timing of the issuance of the stock, in addition to the fact that the ESOP was created at the same time of the issuance, gave the impression that the plan was not created for the purpose of providing benefit to employees, "but rather to solidify management's control of the company."⁶⁸ The second factor considered was the financial impact on the company. On this point, the majority observed that the target company received no real monetary consideration for the shares.⁶⁹ The third factor considered was the identity of the trustees. The court found that all were members of the target company's board of directors. Hence, they provided an additional management entrenchment inference.⁷⁰ The final factor considered was the voting of the ESOP shares. The trustees/directors retained voting control of all the ESOP shares,⁷¹ thus providing them with overall control in the decision-making process.

After finding that Norlin violated these four essential elements, the court held that the sole purpose of the establishment of the ESOP was for the continued solidification of current management.⁷² The result was a breach of the fiduciary duty owed to the company and its shareholders. To demonstrate that the directors showed self-interest with the adoption of the ESOP, the court shifted its focus from the duty of care to the duty of loyalty which "derives from the prohibition against self-dealing

64. The company also transferred stock to a subsidiary located in Panama. *Id.* at 259.

65. *Id.* at 267.

66. The defendant cited the case of Southeastern Pub. Serv. Co. v. Graniteville Co., C.A. No. 83-1028-8 May 19, 1983 as the precedent (the creation of an ESOP is an appropriate step to thwart an attempt to acquire control of a corporation.). *Id.* at 267, n.13. However, the court stated that such would be a viable precedent only in the absence of a showing of self-interest by the board. *Id.* at 267, n.13.

67. *Id.* at 265-66.

68. *Id.* at 265. The court noted that when "an ESOP is set up in the context of a contest for control It devolves upon the board to show that the plan was in fact created to benefit the employees, and not simply to further the aim of managerial entrenchment." *Id.* at 266.

69. *Id.* at 266, n.11.

70. *Id.* at 266-67.

71. *See Id.* at 266.

72. *Id.*

that inheres in the fiduciary relationship."⁷³ Once a prima facie showing of self-dealing was established, the burden shifted to the directors to prove that the ESOP was fair to the corporation.⁷⁴ As the preceding analysis indicates, the directors failed to meet that burden.⁷⁵

An interesting aspect of this case is that although the plan was described as an ESOP, it was not called an employee stock ownership plan; but rather an employee stock option plan and trust, which is different in form.⁷⁶ Nevertheless, the legal reasoning used by the *Norlin* court proved instrumental to the analysis of the ESOP created in light of a hostile takeover attempt. In addition, the language in the opinion tends to indicate that the plan may have, in fact, been an ESOP.

Although *Norlin* sheds some light on the use of ESOPs in corporate practice, a number of questions remain. While the primary importance rests on the duty of directors to the corporation and its shareholders, many of the elements the court considered reflect protective measures with respect to the employee shareholder participants - namely, that the ESOP be fairly administered. Does this mean that the ESOP participants, technically shareholders of the corporation, are placed on the same level of priority as all other shareholders? Or does the duty to the corporation and its shareholders supersede the obligation to ESOP participants so that an ESOP may be permitted even though the plan might place heavy burdens on employee shareholders yet benefit others? The ensuing discussion should provide further insight.

In *Shamrock Holdings, Inc. v. Polaroid Corp.* the court upheld the establishment of an ESOP which thwarted a hostile takeover.⁷⁷ In *Shamrock*, the raider and several current shareholders of Polaroid, the target company, brought suit against Polaroid.⁷⁸ The raider attacked the validity of an ESOP created by Polaroid at the time the raider initiated a tender offer⁷⁹ for all of Polaroid's outstanding common stock.⁸⁰ The plaintiffs

73. *Id.* at 264.

74. *See Id.*

75. *Id.* at 265.

76. *Id.* at 259 (stock options allow an individual the opportunity to purchase shares of company stock at a fixed price for a certain time, even though the price of stock increases during that period).

77. 559 A.2d 257 (Del. Ch. 1989), *aff'd* 559 A.2d 278 (Del. Ch. 1989).

78. *Id.* at 259.

79. *Id.* (noting that a number of considerations reflected on Polaroid's vulnerability as a takeover target, including (1) a decrease in profits, (2) a small amount of debt, and (3) a large amount of unliquidated assets). *Id.* at 261.

80. *Id.* 259.

alleged a breach of fiduciary duty by the target company's board,⁸¹ all of whom were named defendants.⁸² They maintained that the ESOP was used solely as a defensive measure to avert Shamrock's takeover attempt.⁸³

The court began its consideration of the issue by asserting that "directors are responsible for managing the business affairs of a . . . corporation and, in exercising that responsibility, they are charged with an unyielding fiduciary duty to the corporation and its shareholders."⁸⁴ The court stated that where the directors are disinterested, decisions will be protected by the business judgment rule, "a presumption that in making a business decision, the directors . . . acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company."⁸⁵ The court stressed that before the business judgment rule should apply, the directors must show "reasonable grounds for believing that a danger to corporate policy and effectiveness existed, and the defensive measure chosen by the board must be reasonable in relation to the threat posed."⁸⁶ In order to determine if the ESOP was reasonable in light of the attempted takeover, the court considered a number of factors, including the effect the ESOP would have in terms of employee productivity.⁸⁷ The court stated that ESOPs have the benefit of promoting increased employee morale and productivity.⁸⁸ This, combined with the type of relationship Polaroid had with its employees⁸⁹ would result in an effective ESOP that was beneficial to the corporation. The voting of the shares was another important element the court considered.⁹⁰ The ESOP was designed for mirrored

81. *Id.*

82. *Id.* at 260.

83. *Id.* at 269.

84. *Id.* (citing *Smith v. Van Gorkem*, 488 A.2d 858, 872 (Del. Super. Ct. 1985)).

85. *Id.* at 269 (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)). The opinion relied extensively on the case of *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), which, interestingly enough, did not deal with the adoption of an ESOP, but rather established that directors are accorded protection under the business judgment rule in response to corporate takeovers. The *Unocal* case also established that issues to be determined in looking at a takeover bid and its effects on the corporation include "inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities being offered in exchange." *Id.* at 955.

86. *Shamrock*, 559 A.2d at 269-70 (quoting *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985)).

87. *Id.* at 272.

88. *Id.*

89. The court noted there was a "close identification" between the company and its employees. *Id.*

90. *Id.* at 273.

voting and tendering so that in the event of a tender offer, the ESOP shareholders could direct the trustee to tender the shares in their individual accounts. This set-up indicated that the board did not intend to maintain control of the voting of the shares.⁹¹ The timing was another important element. Polaroid had considered adopting an ESOP as an employee performance incentive program for some time.⁹² The fact that the ESOP ultimately proved to be a defensive measure did not, under the court's reasoning, detract from the notion that the plan was established with the employees in mind.⁹³

While these elements, similar to those found in *Norlin*, indicate an awareness that some degree of obligation exists to ensure that ESOPs are administered for the benefit of employee participants, a number of other considerations came into view which indicated that, overall, the primary obligation extends to the corporation and its shareholders. The *Polaroid* court first considered how the ESOP was to be funded, and to what degree it would be funded by the corporation.⁹⁴ In this regard, the ESOP was fundamentally fair because this burden rested on the employee participants, not on the corporation or its stockholders.⁹⁵ Next, the court considered whether the ESOP would dilute the shares.⁹⁶ The court answered by contending that, although the ESOP would initially result in diluting the shares of the public stockholders, such a dilution would be offset by the increased earnings the corporation would experience as a result of the increase in employee efficiency.⁹⁷ Taking all of these considerations into account, the court concluded that the ESOP was fundamentally fair and that the creation of the ESOP was a proper exercise of business judgment.⁹⁸

What becomes apparent from this case is that the creation of

91. *Id.* at 273. The plaintiffs contended that not only would an ESOP stockholder be less likely to tender shares than a public stockholder, the ESOP stockholders would be more friendly to management. *Id.*

92. *Id.* at 261.

93. For a more detailed analysis of the *Polaroid* case and other cases dealing with the establishment of ESOPs as a defensive measure in the face of corporate takeovers, see generally Michael Nassau Et. Al. *ESOP's After Polaroid - Opportunities and Pitfalls*, 15 EMPLOYEE REL. L.J. 347 (1989/90).

94. *Shamrock*, 559 A.2d at 271-72.

95. The sources for such funding included pay cuts, reduction in pay increases, and the elimination of profit sharing retirement bonuses. *Id.* at 271.

96. *Id.* at 274.

97. *Id.* The court noted that this anticipated increase in worker productivity is one of the key elements in allowing ESOPs as a response to takeover attempts. It continued that if "the ESOPs' only purpose were to help thwart hostile takeovers, I doubt that it would be considered entirely fair where it dilutes the public stockholders' earnings per share. However, the evidence is uncontradicted that ESOPs promote productivity." *Id.*

98. *Id.* at 275.

the ESOP was permitted because it was fair to both the public shareholders and the corporation. The implication is that ESOP stockholders are viewed differently from other kinds of shareholders and, that in such conflict of interest situations, the primary interests of the public shareholders will ultimately prevail. The conclusion is that an ESOP shareholder is different in form than the traditional shareholder and will be treated by an entirely different standard.

Reinforcement of this view is found throughout the language of the *Shamrock* opinion. The following passage is particularly striking:

Plaintiffs did stress the fact that the employees . . . were opposed to a pay cut. This fact suggests that the ESOP would not have been implemented in its present form if the decision were put to a vote of the Polaroid work force Although the ESOP may not be terribly popular, there is simply no evidence that the employees will express their displeasure by cutting back on productivity. They still have their jobs which, one must presume, they wish to retain.⁹⁹

In another section of the opinion, with specific reference to the voting of the shares, the court immediately assumed the ESOP stockholders would support existing management. It reasoned that "if an employee were being asked to choose between a better return on his ESOP investment and the possibility that he will lose his job, it is reasonable to anticipate that the employee would forego the investment opportunity in favor of job security."¹⁰⁰

Childers v. Northwest Airlines, Inc.,¹⁰¹ though not dealing with a hostile takeover issue, nonetheless lends support to the proposition that ESOP shareholders are not viewed along the same continuum as other conventional shareholders. In *Childers*, ESOP participants brought suit against the company because their acceptance of promotions resulted in an alteration of their union affiliations, making them ineligible for additional stock allocations.¹⁰² In addition, the promotions came after the deadline for participation in the particular ESOP representing their new employee group. Because of this, they were barred from enjoying the benefits of those particular ESOP plans.¹⁰³

In the first count of the complaint, the employees alleged violations of ERISA provisions. Specifically, plaintiffs alleged

99. *Id.* at 272.

100. *Id.* at 273.

101. 688 F. Supp. 1357 (D.Minn. 1988).

102. *Id.* at 1359.

103. *Id.*

that the defendants breached their fiduciary duty and argued that the participation requirements were "arbitrary, capricious, and unreasonable,"¹⁰⁴ because they acted to deny employees an equal opportunity to participate in the plan.¹⁰⁵ The court dismissed both aspects of this count - holding that defendants, management employees and union officers who served on the ESOP review boards, were not acting as fiduciaries pursuant to ERISA.¹⁰⁶ It contended that "'settlor functions' relating to the formation, design and termination of plans are not fiduciary activities."¹⁰⁷

The court's decision on the second count of the complaint, securities fraud, sets forth the notion that ESOP participants are not perceived as conventional shareholders. The employees claimed that defendants' failure to alter ESOP terms,¹⁰⁸ despite their awareness that those terms prevented program participation upon promotion, violated section 10(b) of the Securities Exchange Act of 1934¹⁰⁹ and Rule 10b-5 of the Securities and Exchange Commission.¹¹⁰ This was a very logical argument, given the fact that ESOPs deal in company stock, and that participation in an ESOP appears to be a type of securities transaction falling within the purview of the 1934 Act and the Rule.

However, despite the apparent strength of this argument, the court dismissed the count.¹¹¹ It held that in order for a cause of action to fall under these provisions, there must be a "purchase or sale,"¹¹² and that the test is not satisfied under ESOPs. First, there is no mention of coverage of ESOPs in the 1934 Act.¹¹³ As to the assertion that the ESOP constituted an investment contract, which does fall under the Act, the court maintained that the proper test is one where "the scheme involves an investment of money in a common enterprise with profits coming solely from the efforts of others."¹¹⁴ The court reasoned that while an ESOP may be considered a common venture, the plaintiffs did not invest in it expecting to reap profits as a result of the

104. *Id.* at 1360.

105. *Id.*

106. *Id.*

107. *Id.* at 1361. The court also dismissed the allegation that defendants breached their fiduciary duty by failing to inform that promotions would exclude plaintiffs from ESOP participation. It held the contention had no "basis in law." *Id.* at 1361-62.

108. *Id.* at 1362.

109. *Id.*

110. *Id.*

111. *Id.* at 1363.

112. *Id.* at 1362.

113. *Id.*

114. *Id.* at 1363.

management of the trust itself.¹¹⁵ In having the ESOP funded with the company's stock, "any appreciation in the value of the stock would not be attributable to the management of the ESOP, but to the financial recovery of [the company] as a whole."¹¹⁶

The court also concluded that an ESOP is a compulsory and noncontributory plan, and as such, participants had not provided "a specific consideration in return for a separable financial interest with the characteristics of a security."¹¹⁷ Plaintiffs maintained that they did furnish the requisite value because participation in the plan was contingent upon a fifteen percent wage reduction.¹¹⁸ The court countered their contention by holding that the company "demanded wage concessions in an attempt to preserve its cash resources and working capital . . . the ESOPs were primarily a method of deferring income, not a method of reducing wages to pay for stock."¹¹⁹

However, the significance of *Childers* lies not in whether plaintiffs would have ultimately prevailed on the securities violation issue, (the court dismissed that count of the complaint on the ground that plaintiffs did not belong to the category of shareholders who may properly assert a securities fraud claim under the 1934 Act and Rule 10b-5); rather, its significance lies in its conclusion that ESOP shareholders are not like conventional shareholders and, because of this, will be treated differently when the circumstances call for it.

Despite the fact that ESOP shareholders may be viewed in a different light, the ESOP concept itself should not be abolished altogether. Even the takeover cases indicated that many of the factors considered with respect to the creation of plans concern the assurance that the trusts be fairly administered. This is true even though the primary obligation of management extends to the corporation and its shareholders. This seems quite sensible. Aside from the protection afforded plan participants under ERISA, it is logical to conceive that a company adopting an ESOP which is not in the best interests of the employees will discover that the corporation and all of its shareholders will be adversely affected in the long run due to a decrease in employee motivation and morale.

IV. THE CONTROL QUESTION

One of the primary complaints surrounding the use of ESOPs is

115. *Id.*

116. *Id.*

117. *Id.*

118. *Id.* at 1359.

119. *Id.* at 1363.

that workers have no control over the company's management, despite the fact that they are entitled to a share of the company's earnings. Consequently, it is not actual ownership. Granted, control of the company's management is not an ESOP requirement. In fact, in many cases, the trustees, as directed by management, vote the shares in the ESOP account.¹²⁰ The problem lies in the assertion that votes by the trustees do not reflect the attitudes of the employees, but rather, those of management.

One rudimentary answer to this is that congress did not create ESOPs with the purpose of worker control in mind, nor have ESOPs been implemented primarily as a worker control device.¹²¹ Also, most leveraged buyout companies maintain a management structure similar, if not identical, to the pre-buy out firm.¹²² Still, others maintain the opinion that if employees receive wider control via their voting rights, ESOPs would truly resemble a situation of democratic worker ownership.¹²³

Voting rights are available with ESOPs. The rights are limited in private companies. They must be permitted to vote their shares on major issues, such as closing or relocating.¹²⁴ Although employees must be able to vote on all issues in public companies, this is not a controlling interest.¹²⁵ However, a growing number of companies allow full voting rights, because research has indicated that "employees are conservative shareholders who almost always vote for existing management."¹²⁶

The result of these voting rights may have implications on both sides of the spectrum. On one side, those arguing in favor of granting employees broader control through their voting rights and representation on the board of directors might say that changes in corporate structure and policy would not change dramatically due to this conservative worker attitude. Conversely, corporate management can argue that because employee shareholders back current management, simply having their shares voted by a qualified trustee would suffice. Besides, they can further contend that granting such control is by no means a guarantee that the firm will ultimately succeed.¹²⁷

120. Rosen, *supra* note 29, at 18.

121. Hyde & Livingston, *supra* note 13, at 1139.

122. Rosen, *supra* note 29, at 19.

123. Dentzer, Friday & Cohn, *supra* note 7, at 59.

124. Rosen, *supra* note 29, at 17.

125. *Id.* at 19.

126. *Id.*

127. One such instance involved a company called South Bend Lathe, which was purchased by its employees with an ESOP. The employees demanded, and received, a controlling interest on the board of directors. Unfortunately, the firm went bankrupt, despite its efforts. Rosen & Cohen, *supra* note 30, at 218-219.

It is pertinent to note that while it is asserted that employee control is not a priority with respect to the adoption of an ESOP, *Polaroid* and *Norlin* demonstrate that voting rights are an important factor in determining whether or not the ESOP was properly administered.

V. ESOPS AND WORKER PARTICIPATION: A PRODUCTIVE COMBINATION

While Congress and the courts attempt to ensure that ESOPs maintain the interests of the employee shareholders as a primary objective,¹²⁸ the issue still remains whether they are as effective as initial intentions, and in which instance are ESOPs the proper vehicle towards improved employee motivation and productivity. Obviously, an ESOP initiated solely for the purpose of reaping tax benefits is arguably not in the best interests of the employees and would probably defeat Congress's intended purposes. Research indicates that ESOPs have their most dramatic effect on employee morale, motivation, performance, and productivity "if and only if the company combines ownership with a high degree of employee participation at the job level."¹²⁹ Studies also reveal that companies combining ESOPs with worker participation programs grow three to four times faster than companies that solely establish the only trust alone.¹³⁰ In addition, these firms grow at a yearly rate that is 8 percent to 11 percent faster than those firms owned and managed through conventional means.¹³¹

One great ESOP/worker participation success story is the Avis Company. Employees at Avis purchased the company in 1987 for \$1.75 billion. This purchase was intended to stabilize a firm which constantly changed corporate owners.¹³² The results were positive, with company performance increasing to an extent so great that even Avis customers signaled their satisfaction with the employee ownership concept.¹³³ This approval is the subject of widely seen advertisements in which customers exclaim: "I know the owner".¹³⁴ Of significant importance is the degree of worker participation sponsored by the company. Monthly meetings at the local level, attended by management and employee representatives, are held nationwide. Regional and national meetings, as well as a communications program, prove to be conducive to effective employee

128. This may not necessarily always be the situation, as the corporate takeover cases discussed above demonstrate.

129. Rosen, *supra* note 29, at 19.

130. See READER, *supra* note 25, at 3.

131. *Id.* at 36.

132. Ungeheuer, *supra* note 26, at 51.

133. *Id.*

134. *Id.*

involvement.¹³⁵

Of similar fascination is the Polaroid case because, as discussed earlier, the court approved the ESOP despite the court's own cognizance that the company's employees would not have voted for the trust.¹³⁶ The court, however, noticed Polaroid's impressive history of worker participation policies in weighing its decision concerning the possible benefits of the ESOP.¹³⁷ As the court stated:

Another important aspect of Polaroid's culture . . . is its emphasis on employee involvement in the success of the company. In its early years, when Polaroid was a small company, Dr. Land [Polaroid's founder] promoted a "family" atmosphere by maintaining open and formal lines of communication between workers and management and by encouraging employees to share in management's goals for growth and profitability. For example, Dr. Land held annual meetings with the employees to discuss the company's performance and future plans. He also created an Employee's Committee (the "EC") shortly after World War II to represent employees in connection with grievances or other work related problems and to assist in the preparation and evaluation of policies affecting employees. As the company grew, other efforts were made to maintain a high level of employee identification with the company.¹³⁸

Apparently, these efforts have paid off. Following the first year of the ESOP's implementation, Polaroid enjoyed profitability that surpassed analyst expectation.¹³⁹

Firms with such worker participation schemes will more closely resemble true worker-owned organizations. These employees will perceive that they possess a greater influence in business operation decisions, evidently reaping numerous benefits. This scheme ensures that corporate goals will be realized. With increased communication at all levels, the employees, as owners,¹⁴⁰ have a real stake in the firm's success and as worker-

135. See generally NATIONAL CENTER FOR EMPLOYEE OWNERSHIP, THE EMPLOYEE OWNERSHIP CASEBOOK (1986), [hereinafter CASEBOOK]. The CASEBOOK, revised annually, is a publication of the National Center for Employee Ownership (NCEO), a non-profit research and membership organization in Oakland, California. The CASEBOOK is available from the NCEO for a fee.

136. Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 257, 272 (Del. Ch. 1989), *aff'd* 559 A.2d 278 (Del. Ch. 1989).

137. *Id.* at 260.

138. *Id.*

139. CASEBOOK, *supra* note 135.

140. See Hansmann, *supra* note 5, at 1762.

owners, will monitor each other's progress. In addition to this obvious opportunity for increased financial strength, employees will be more likely to remain with the company, refining and specializing their skills, resulting in overall greater productivity, efficiency, and harmony. Lastly, these worker participation programs serve to open communication channels between all levels, further reducing problems between workers and management.

Additionally, increased participation will have certain psychological benefits, in that employee-owners will have a greater degree of satisfaction from collective decision making¹⁴¹ and from a sense of relative control. The diminished chances for conflict between management and workers represents another advantage when considering that worker ownership is at its best when conflicts of interest are at a minimum.¹⁴² Finally, worker participation programs induce a situation where the worker-owners believe that they are on the same "team" as management "promoting homogeneity of interests among the worker-owners."¹⁴³

VI. CONCLUSION

Despite the controversies, ESOPs remain a viable alternative for firms desiring to distribute their wealth to employees. This analysis has indicated that something beyond simply making employees beneficiaries of a share of the profits may be necessary. Ideally, employees could receive control of the firm by obtaining a controlling interest through their voting rights. Realistically, in most instances ESOPs will not yield such a result. However, the analysis indicates that short of this actual control interest, companies implementing ESOPs with worker participation programs will enable ESOPs reach their maximum potential. Additionally, without the tax advantages, many firms would not even consider ESOPs. In fact, only about 7 percent of those firms with ESOPs in effect have indicated that they would organize the trust absent tax incentives.¹⁴⁴

While many detractors argue that the above tax reality represents sufficient evidence to rule out ESOP's all together, this comment contends that the tax advantages represent a necessary means to the desired end that ESOPs are adopted.

Congress has adopted a great number of provisions to safeguard that ESOPs are carried out for the benefit of the employee-owners,

141. *Id.* at 1769.

142. *Id.* at 1784.

143. *Id.* at 1785.

144. ROSEN ET. AL., *supra* note 3, at 26.

who are the beneficiaries of the trust. The courts are also doing their part to ensure that ESOPs, when in dispute, are not abused by companies as a management entrenchment device or a method of self-dealing. In addition, those firms creating ESOPs solely for the purpose of reaping attractive tax advantages and nothing more, may soon find that such abuse will ultimately result in a hinderance of overall corporate objectives rather than corporate benefits. Companies that argue worker participation may be too time consuming or costly have forsaken the true intent of the ESOP scheme. Investment in these programs is fair in light of the substantial tax benefits reaped. Those firms using ESOPs wisely (by taking the time and effort to increase the lines of communication and to encourage employee participation at all levels of the organization), will reap the benefits of an effective ESOP plan. At the same time, workers will feel more like owners in the sense that they will have a greater stake in the success of the company beyond the receipt of shares. In this way, ESOPs will serve as the catalyst for an environment that resembles what many hope will be a representation of effective, democratic worker ownership.

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