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## **THE GOVERNANCE OF ESOPS IN UNITED STATES: limits of and alternatives to the 'patrimonial' model.**

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## THE GOVERNANCE OF ESOPS IN UNITED STATES: limits of and alternatives to the ‘patrimonial’ model.

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*The present article attempts to shed some light on the particular issue of ESOPs’ governance in public companies.<sup>1</sup> It shows that the institutional configuration of ESOPs conveys an affiliation to a governance logic qualified as “patrimonial”, by reference to the works of the French Economist Aglietta, who stated that, from a macroeconomic point of view, the gradual financialization of salary wages is but one of the facets in the emergence of what he calls a ‘finance-led’ regime of growth. Through a series of case-law examples, it highlights some difficulties encountered in the regulation of ESOPs and some of the ways in which ESOPs fail to serve their indented purpose as a means of involving employees in ownership of their firm. Then, without especially asserting that there is a direct causal link between the “patrimonial” orientation and the highlighted difficulties, it points the need for a reconsideration of the institutional organization of plan governance itself. As an illustration, it mentions some alternative forms of plan governance that are nowadays emerging or existing, be it inside the US legal system or outside, and which organize an institutional participation of employees in the implementation and governance of employee share ownership schemes, a type of governance termed “partnerial”.*

In an era of financialization – understood as the growing appeal to the shareholder value norm as the main indicator for directing corporate strategy - employee stock ownership is regarded as a major tool to facilitate the creation of financial value. Indeed, the Economics literature on the theory of the firm, describes employee stock ownership as an incentive contractual mechanism that aims to minimize the costs resulting from the agency relationship between the employer and its employees. Although they were not especially sympathetic to employee ownership and co-determination, authors such as Jensen and Meckling have argued that workers financial participation reduce agency and bonding costs by providing employees with incentives to share information and to give commitment to the financial wealth of the shareholders thanks to the alignment of workers’ interests with those of

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<sup>1</sup> ESOP is the abbreviation of ‘Employee Stock Ownership Plan’.

shareholders<sup>2</sup>. Indeed, a defining feature of economic theories of the firm is the agency concept which deals with the problems arising in bilateral relationships of an asymmetric kind. Typically, there is a 'principal' who wants to accomplish some projects he can't do by himself, who hires an 'agent' to do some actions on his behalf. This principal-agent relationships poses efficiency problems if the principal can not monitor the agent perfectly or when he can not accurately judge the quality of the agent's work. The problem, then, is how the principal can write a contract in such a way as the agent is motivated to do his best to accomplish the principal's goal.<sup>3</sup> In the case of employee share ownership, the manager-employer (himself acting as agent of the shareholders) acts as the principal of the employees who act as agents.

In the United States, 'Employee Stock Ownership Plans', better known as ESOPs, are certainly the most widespread employee share ownership schemes. According to a statistical profile published by the 'National Centre for Employee Ownership' in March 2005, there are at present 11,500 ESOPs covering about 10 million workers, and representing an estimated \$500 billion worth of plan assets.<sup>4</sup> Most companies with ESOPs are closely held. However, because public companies have, on average, many more employees than private companies, most ESOP participants are in public companies.

The present article attempts to shed some light on the particular issue of ESOPs' governance in public companies. We would like to show that the institutional configuration of ESOPs - broadly conceived as including elements of tax law, labour law and financial law – conveys an affiliation to a logic that we may qualify as 'patrimonial'. The term 'patrimonial' finds its roots in the works of the French economist Michel Aglietta, who stated that, from a macroeconomic point of view, the

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<sup>2</sup> See generally, H. HANSMANN, *The Ownership of Enterprise* (Harvard University Press, Cambridge M.A and London, 1996).

<sup>3</sup> Jensen and Meckling studied the firm through the principal-agent theory lens. They analysed the problems of incentives and control based on asymmetrical distribution of information between principals and agents. They emphasized the monitoring costs for employers (acting as the principal) given that employees (acting as the agents) have superior information about the production process and the bonding costs to employees arising from the possibility that employers will in the future take most of the gains arising from the performance of the human capital. See JENSEN, M. MECKLING, W., (1979), Rights and production functions: an application to labor-managed firms and co-determination, 52 *Journal of Business*, 469-506.

<sup>4</sup> [www.nceo.org/library/eo\\_stat.html](http://www.nceo.org/library/eo_stat.html)

gradual financialization of salary wages<sup>5</sup> is but one of the facets in the emergence of what he calls a ‘finance-led’ regime of growth<sup>6</sup>. Although there are several interpretations of this evolution, they all agree on assigning to market finance a decisive role in both the creation and distribution of value added. The work of Aglietta, a prominent member of the French *Régulation* School, has been influential in the analysis of contemporary industrial societies. In particular, his account of a crisis of ‘Fordism’ has found a wide echo among scholars attempting to study the relationships between markets, social institutions and public policy. In his work, Aglietta shows that the rise to power of market finance since the mid-1970s has altered the overall makeup of the institutional system known as ‘corporate governance’ by which he means all the measures, procedures, institutions and practices that determine the exercise of power in firms during a given period. For Aglietta, because market economies can function effectively only in a well-defined institutional context, there is a need to search for institutional forms adequate to current economic development while promoting social progress as a precondition to economic prosperity. It is not the point, here, to describe more extensively the *Régulation* approach<sup>7</sup>. The present focus is rather on the influence of ‘financialization’ on the institutional makeup of the ESOP system. We would like to show that ESOPs regulation bears the mark of the gradual establishment of a ‘patrimonial’ regime of growth. It is in this sense that the ESOPs governance model can be termed ‘patrimonial’.

The second objective of this contribution is to identify, some difficulties encountered in the regulation of ESOPs, which are as much ways in which ESOPs fail to serve their intended purpose as a means of involving employees in ownership of their firm. The third objective is to contrast the patrimonial model of ESOPs governance with alternative proposals that are emerging or existing today, be it inside the US legal system or outside, and which organize an institutional participation of the employees and their representatives in the implementation and the management of their plan, a type of governance mechanism we therefore qualify as ‘partnerial’.

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<sup>5</sup> Strictly speaking the financialization of salary wages refers to those elements of the employees’ pay that can be regarded as financial assets, as is the case with ESOPs.

<sup>6</sup> AGLIETTA, M., *Régulation et crises du capitalisme*, Paris, Odile Jacob (1997); « Le capitalisme de demain », *Notes de la Fondation Saint-Simon*, n°101 (November 1998). See also, AGLIETTA, M., REBERIOUX, A. *Corporate Governance Adrift*, (Edward Elgar, London, 2005)

<sup>7</sup> GRAHL, J., TEAGUE, P., “The *Régulation* School, the employment relation and financialization”, 29 *Economy and Society*, 160-178 (2000).

The present contribution is structured as followed.

We will first describe the ESOPs mechanism in order to show its 'patrimonial' orientation.

After that, through a series of case-law examples, we will highlight some difficulties related to the possible instrumentation of ESOPs by managers in order to realize business or financial strategies that are potentially detrimental to the employees' interests.

Then, we will point out the need for a more systematic consideration of alternative governance techniques through which policy makers can make it easier to take into account the interests of plan participants.

## I. Esops: some basic concepts

In US legislation, an Employee Stock Ownership Plan is a qualified retirement plan designed to invest primarily in employer stock, thus providing employees with an ownership interest in their employer's company<sup>8</sup>. Although other retirement plans may invest in employer stock, these plans may invest only up to 10% of plan assets in employer's securities. One of the main features of Esops is that they are legally exempted from this limit and so, they can be primarily invested in employer securities.

The 'Employee Retirement Income Security Act' (ERISA) of 1974 governs Esops, granting them many exceptions to the principles of protecting retirement income applicable to ordinary pension plans. One of the most notable exceptions is logically the lack of diversification requirement, the Esops being chiefly oriented towards internal shareholding.

According to the general principles governing Esops, a trust is established to purchase shares of the company stock from either the company itself or its existing stockholders. In the case of a leveraged Esop, the Esop - or the company setting up

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<sup>8</sup> ESOPs are defined in the I. R.C (Internal Revenue Code) § 401 (a), § 4975 (e) (7) (1998) and in ERISA (Employee Retirement Income Security Act) § 407 (d) (5). But, because the definitional criteria of the IRC are stricter, the definition of the tax legislator prevails: "*an ESOP is a defined contribution plan ... which is a stock bonus plan which is qualified, or a stock bonus and a money purchase plan both of which are qualified under section 401(a) and which are designed to invest primarily in qualifying employer securities.*"

the Esop – borrows the money to purchase the corporation's stock, and then uses the dividends to pay back the loan.

As a matter of public policy, the US legislator has granted significant tax advantages to encourage the implementation of employee stock ownership plans. Contributions to an Esop as well as dividends paid to the participants or to the plan<sup>9</sup> are tax deductible to the corporation<sup>10</sup>. In addition, for a leveraged Esop, the dividends used to pay off the loan are untaxed<sup>11</sup>. Furthermore, a stockholder of a closely held corporation selling thirty percent or more of its shares of stock to an Esop can defer federal income taxes on the sale by reinvesting the proceeds in stock and bonds of a US company.<sup>12</sup> Finally, employees are taxed on distributions when made, but can use certain averaging and rollover provisions not available to non pension plan compensation<sup>13</sup>.

In a typical leveraged Esop, the corporation borrows funds from a bank to buy existing shares. In turn, the plan exchanges a note for a proportion of the stock. Then, the corporation makes annual cash contributions to the plan. The plan immediately returns the funds to the corporation to repay the note, and the corporation in turn repays the bank. So, employees finance their acquisition of company stock with money borrowed by the company and repaid with company earnings that are channelled through the Esop. Thanks to the tax incentives, funding repayments through the plan permits the company to repay debt with pre-tax income in the form of deductible plan contributions. In other words, the leveraged Esop technique allows the company to borrow money and, upon repayment, deduct principal (up to 25% of payroll expenses) and interest.

The advocates of Esops tax incentives highlight their supposed benefits to the market economy: employee stock ownership helps transform workers into capitalists, thereby

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<sup>9</sup> In this case, it is supposed that the dividends are used to pay ESOP debt on the acquired shares. See IRC § 404 (k).

<sup>10</sup> As far as the company contributions are concerned, they are deductible up to 25%. See IRC § 404 (a) (3).

<sup>11</sup> IRC § 404 (a) (9).

<sup>12</sup> IRC Section 1042.

<sup>13</sup> Moreover, before the 1996 'Small Business Job Protection Act', in the cases where an ESOP acquired more than fifty percent of the corporation's stock, the lender was authorized to exempt fifty percent of the interest income from taxation, which often resulted in the lender charging a lower rate of interest.

improving productivity and broadening the capital base; society will then be better off because the inequalities in the distribution of wealth will be lowered and savings and investments increased<sup>14</sup>.

It is not our intention here to discuss the relevance of this argument<sup>15</sup>. Let us just bear in mind that the tax advantages associated with Esops have influenced their relative desirability and their use by companies. In other words, they have helped companies to realize financial and business operations less expensively than through conventional financing. Indeed, Esops and especially their leveraged version have been used for financing corporate growth, tender offers and acquisitions. Let us take the example of a firm wanting to expand its production by financing the purchase of new machinery. If the firm doesn't have an Esop, the employer would go to a bank to borrow money and will repay the loan and its interest just as an individual would do with a charge account. Although the interest payment would be tax deductible, the principal payments on the loan would not. The use of a leveraged Esop for this purpose greatly helps the employer because it allows him to repay the borrowed sum with tax deductible dollars. Since the principal and interest repayments are deducted before the employer's taxable income is determined, the taxable income is lower than through regular borrowing and thus the employer's taxes are reduced. The result is that the new machinery will be much more affordable when borrowing the money through the Esop technique than through conventional financing. Moreover, it is supposed that the gains generated by the new machinery – in terms of increased productivity gains – will help the employer to pay its contributions to the plan, in order to enable it to repay the loan.

As we will see, the financial leverage offered by the Esop mechanism has given rise to a potential tension between, on the one hand, the right of firms to utilize the plan

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<sup>14</sup> L. KELSO & M. ADLER, *The Capitalist Manifesto* (1958), L. KELSO & M. ADLER, *The New Capitalists: a Proposal to Free Economic Growth from the Slavery of Savings* (1961); L. KELSO & P. HETTER, *How to Turn Eight y Million Workers into Capitalists on Borrowed Money* (1967); L. KELSO & P. HETTER, *Two -Facto Theory: The Economics of Reality* (1967); L. KELSO & HETTER, "Employee Stock Ownership Plans: a Micro Application of Macro-Economic Theory" (1977) 26 *Am. U. L. Rev.*, 530; R. LONG, « Employee Stock Ownership Plans : Spreading the Wealth to the Average American Worker" (1977) 26 *Am. U. L. Rev.*, 515-518; J. BLASI, *Employee Ownership : Revolution or Rip-off ?* (New York: Ballinger, 1988), 3.

<sup>15</sup> R. L. DOERNBERG & J. R. MACEY, "ESOPs and Economic Distortion" (1986) 23 *Harvard Journal on Legislation*, 103; Michael W. MELTON, "Demythologizing ESOPs" (1990) 45 *Tax Law Review*, 364.

as a financing tool that will generate wealth in the economy<sup>16</sup> and, on the other hand, the legal requirement that the plan assets be managed in the sole interest of the plan participants and beneficiaries. Participant refers here to the individuals who are or have been enrolled in an ESOP and who are or may become eligible to receive or are currently receiving a benefit under the plan, or whose beneficiaries are or may become eligible to receive a benefit. Beneficiary refers to the person, other than the participant, who is designated by a participant or by the plan to receive a benefit under a program (such as a spouse, a child).

According to the general principles, stock ownership conveys two fundamental entitlements: the right to collect the residual benefits generated by the firm and the right to exercise the voting rights attached to the shares of stock. However, being subject to the legal standards governing pension plans, the Esops evade the general law applicable to traditional shareholding. From this point of view, three aspects are relevant.

First, Esops are governed by a set of rules located within the regulatory framework of ERISA and inspired by trust law. The assets of the plan must be held in trust and managed by a trustee, the purpose being to enforce the separation of the plan assets from employer assets and invoke the protections of the law of trusts. With respect to the parties involved in the management and operation of the plan, we should note that ERISA characterise the persons responsible as trustees or 'fiduciaries'. For several reasons, the legislator has considered that the strict trust-law model was not appropriate to employee benefit plans which involve ongoing and often complex

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<sup>16</sup> When the ESOPs legislation was enacted, Congress had explicitly recognized the legitimacy of the financial use of ESOPs. The congressional view underlying the leveraged ESOP program was founded on the premise that future wealth can be created through access to subsidized credit. William R. Levin summarizes well the three objectives that the ESOP legislation is supposed to achieve: "First, Congress asserts that access to subsidized financing creates wealth for the employees. This argument relies on a model of project finance in which a firm identifies a valuable investment opportunity, such as the construction of a new plant. Corporate borrowing through the ESOP finances the facility. The plan generates the cash required to repay the ESOP loan and continues on to generate purchasing power for the owners who are now working Americans, instead of the already wealthy capitalist elite. Second, Congress states that fairness and equity require the program as the means to distribute future wealth over a broader base (...) Third, Congress accepts as fact that increased ownership improves productivity citing empirical studies showing higher productivity and improved financial performance for worker-owned versus non-worker-owned firms. The supporting intuition suggests that employees work harder when they are shareholders." in W. R. LEVIN, « The False Promise of Worker Capitalism : Congress and the Leveraged Employee Stock Ownership Plan" (1985) 95 *Yale Law Journal*, 158-159.

activities. Indeed, classic trust law implies a 'one size fits all' approach with a unique trustee who exists to carry out the aim of the settlor and is under a duty to avoid delegating responsibility. This approach does not suit plans which, as a result of their size and particularities, often need a division of managerial, financial and administrative responsibilities. ERISA recognizes this. It treats responsibility for the plan management and operation as divisible and thus allows for the possibility of various persons responsible, each with an area of specialization. The trustee is but one of the statutorily defined responsible actor. As long as some of its fiduciary responsibilities have not been delegated to other 'fiduciaries', he keeps all significant power and responsibility for administering the plan held in trust. One of the principal characteristics of ERISA's regulatory scheme is its fiduciary requirements<sup>17</sup>, the most relevant being the duty of loyalty or exclusive benefit rule. This exclusive benefit rule is the method of dealing with the issue of representation of plan participants in the plan governance; it simply and directly rules out any consideration not clearly in the best interest of plan beneficiaries. ERISA Section 403(c) stipulates: « the assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purpose of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan. ». It follows from this fiduciary perspective that a high degree of unity of interests between the plan participants must be presupposed: it does not contemplate separate analysis with respect to each beneficiary's interest, but rather a single collective approach. We will see hereunder that the US labour Department's and the Courts' interpretations of ERISA impose a residual paternalistic duty on the trustee that sometimes requires disregarding participants' instructions when deemed contrary to participants' collective interest.

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<sup>17</sup> The fiduciary duties of pension plan trustees are specified in ERISA, Section 404 (a) (1): « A fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and (A) for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan and (B) 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 and with like aims ; (C) by diversifying 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 ;(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter and subchapter III of this chapter »

Secondly, trustees and plan fiduciaries are appointed to represent the interests of plan participants and beneficiaries but their appointment reflects their position in their home organization. With some exceptions, trustees and plan fiduciaries are named by the sponsor corporation's board of directors or by a committee appointed by the same board and are subjected to the direction and authority of the appointing group. Thus, because they depend upon the sponsoring corporation for their nomination, it is inevitable that they reflect the latter's interests, even if those interests are supposed to be irrelevant to their fiduciary obligations.

Thirdly and more seriously than the limited participation afforded in the governance of the plan itself is the complete absence of participation afforded in connection with the adoption and termination of the plan. Unless the workforce is unionized, employers can institute an Esop unilaterally on their own terms, and unless the plans give employees more control than they typically do, employers can terminate Esops unilaterally.

## II. **ESOPs: Difficulties encountered by the patrimonial model.**

In their operation, Esops generate whirlwind potential conflicts of interests between the actors involved, mainly plan participants, fiduciaries and employer. This section will illustrate some of these conflicts through some case law examples. It is not our intention here to be exhaustive and to cover all the difficulties engendered by the Esop mechanism. We simply wish to highlight four types of conflict scenarios which show that, under the current governance structure, individual workers are poorly equipped to ascertain that the Esop tool isn't actually used for strategies potentially harmful to their interests.

The first point of tension we'd like to pinpoint relates to the evaluation of the employees' exclusive benefit. Like we said in the previous section, Esops are regulated as pension plans, which make it very difficult for employees-shareholders to be assimilated to full-fledged shareholders. Rather, employees are considered as

participants to an Esop trust where only the trustee exercises most of the stockholder rights. In turn, the trustee must handle the stock on behalf of the participants as retirees and for their exclusive benefit. If he does not do so, he may be held personally liable for any financial losses to the participants. This exclusive benefit rule is supposed to guide the trustee action and to guarantee employees the necessary protection against any trustee decision potentially detrimental to their best interests. However, ERISA does not specify what scope should be given to the notion of 'exclusive benefit'. In other words, it leaves unclear the manner according to which the best interests of plan participants must be appreciated and measured and what kind of interest is at stake. From this point of view, the case law offers some interpretative guidelines. According to the US Labor Department interpretation of ERISA as well as the Courts', the trustees must act in the sole financial interests of the plan participants and beneficiaries. That is to say, the evaluation of the participants and beneficiaries' interests is made according to a monetary logic: before each action, the trustee must determine whether the planned decision conforms to the collective, single and unequivocal criterion of financial benefit. He simply must rule out any other consideration related, for instance, to the impact of the decision on employment, on the viability of the firm or on the preservation of the environmental quality. In *Summers v. State Street Bank & Trust Co.*, the Seventh Circuit addressed precisely this issue.<sup>18</sup> In this case, the technical problem was linked to the valuation of employer securities. According to ERISA, Section 408 (e), an Esop cannot pay more than 'adequate consideration' for employer securities purchased from a party in interest. More precisely, ESOPs are exempted from the 'prohibited transaction rule' which, in the case of traditional pension plans, prohibits transactions with party in interest. This exemption, which is logical in the chief of ESOPs that have precisely authority to transact with their parent company (i.e.: buy employer stock, borrow money from the employer to buy stock, etc.), is conditional on the respect of an 'adequate consideration' criteria defined at ERISA § 3(18)(B) as:

*"(i) the price of the security prevailing on a national securities exchange which is registered under Section 6 of the Securities Exchange Act of 1934 or*  
*(ii) if the security is not traded on such a national securities exchange, a price not less favorable to the ESOP than the offering*

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<sup>18</sup> *Summers v. State Street Bank & Trust Co.*, 104 F. 3d 105 (7<sup>th</sup> Cir. 1997).

*price for the security as established by the current bid and asked prices quoted by persons independent of the issuer and any party in interest.*

*(iii) in the case of a security not freely tradable, adequate consideration means the fair market value of the security as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and the DOL regulations.”*

The question was whether the State Street Bank and Trust Company acting as trustees of the United Airlines Esop breached their fiduciary obligations to plan participants by paying too much for stock acquired on behalf of the Esop. More precisely, the Court had to determine whether the fiduciary must take into account the value of wages and other concessions made by plan participants as part of the consideration paid by the plan for the employer securities. Indeed, the United Airlines Esop transaction was characterized by the fact that employees had negotiated with their employer to receive stock in exchange for reduced wages and labor amenities.<sup>19</sup> If the wages and concessions of United employees were considered as assets of the retirement plan, then the trustee couldn't exchange them for securities worth less. The Court of Appeal ruled that the trustee did not have to include the economic value of negotiated employee concession in determining the price to be paid by the plan for the employer stock. The Court held that to favor participant's employee-related interests, such as wages and other labor amenities, would cause the trustee to violate its duty to participants and beneficiaries, some of them being retirees. Above this, the plaintiffs' argument that the trustee improperly neglected to value their concessions in the framework of the Esop negotiated transaction, would wrongly imply that the wages and other benefits of United's employees had been assets of the plan beforehand.

A second fundamental area in which conflicts of interests occur is in takeover battles involving an Esop, its participants and its trustees. Esops are, indeed, likely to be used as takeover deterrents because, in takeover battles, they can protect the firm against a hostile bid by giving control rights to parties - the workers - that have a

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<sup>19</sup> For more details on the United Airlines ESOP case, see, J. N. GORDON, « Employee Stock Ownership in Economic Transitions: the Case of United and the Airline Industry », in M. M. BLAIR & M. J. ROE (eds.), *Employees and Corporate Governance* (Brookings Institution Press, Washington D.C., 1999), 317.

higher reservation price for tendering a bidder<sup>20</sup>. Being pension plans that can be leveraged and must have the majority of their assets invested in the sponsoring firm's equity securities, Esops enable the firm to quickly place a large block of its own stock in supposedly friendly hands. This possibility to use ESOPs as takeover shields has spawned an interest in how Esop shares of stock should be voted or tendered. Commonly, a firm will create an Esop shortly before or at the onset of a tender offer, as it knows management control the right to vote and tender the majority of its stock. Also, the ESOP written instrument will include special provisions restraining the freedom of the trustee in tender offers; or more simply, the management of the plan will be retained by a trusted corporate officer. Close judicial scrutiny of those techniques have thus been necessary. In the *Donovan v. Bierwirth* case<sup>21</sup>, the Court made it clear that an employer struggling to retain control in the context of a hostile tender offer, couldn't act appropriately as a fiduciary directing decisions on behalf of Esop participants. As a consequence of this decision, most ESOPs have implemented alternative methods of dealing with voting rights when the corporation is faced with a hostile bid. Pass through voting (or pass through tendering) and mirrored voting (or mirrored tendering) are certainly the most frequent of those techniques. Pass through voting means that the plan participants retain the right to vote (or tender) in case of takeover. Mirrored voting means that the ESOP trustee must vote (or tender) the unallocated shares of the plan in the same proportion of the allocated shares, that is, the shares that have been individualized because they have been allocated to the individual accounts of participants. In order to evaluate the legality of these kinds of provisions, ERISA fiduciary rules have been considered. Without going in more detail into this interesting though complex issue<sup>22</sup>, the important question here is whether and to what extent a trustee may be held liable for following participants' voting or tender decisions that are not strictly in their best interest, such as where participants vote or tender their shares to preserve their jobs or the viability of their company.

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<sup>20</sup> S. CHAPLINSKY & G. NIEHAUS « The Role of ESOPs in Takeover Contests » (1994) 49 *Journal of Finance*, 1451.

<sup>21</sup> *Donovan v. Bierwirth*, 680 F.2d 263 ( 2d Cir. 1982).

<sup>22</sup> See notably, G. M. AGRESTA-RICHARDSON, « Employee Stock Ownership Plans : Uncertainties Plaguing the Duties of the ESOP Fiduciary with Respect to Voting and Defensive ESOPs » (1999) 14 *Akron Tax J.*, 91; R.C. SISKE, « Employee Stock Ownership Plans : Current Twists and Turns » (2000) *SE93 ALI-ABA* 1091.

As far as voting allocated shares are concerned – that is, shares that have been attributed to the individual plan participants -, the Department of Labor (DOL) and the Courts have established slightly different standards. The federal Courts have strictly applied principles of trust law, their purpose being to safeguard the rights of plan participants without violating ERISA. In *FirsTiers Bank, N. A. v. Zeller*<sup>23</sup>, the Court imposed the duty of independent inquiry on the appropriateness of the plan's participants, but only when given direction by another fiduciary which is not a trust beneficiary. This means that, in evaluating a tender decision, the trustee may eventually disregard the instructions of an ESOP committee (composed, for instance, of management representatives), but cannot disregard instructions coming from plan participants themselves. The DOL's position is slightly different. It applies a facts and circumstances test, evaluating the type of instructions which the participants are giving. The ruling of the DOL in the 'Carter Hawley Hale Letter'<sup>24</sup> is that a participant directed instruction is lawful under ERISA only if the trustee has determined that the participant had in fact rendered an independent decision in directing the trustee, without coercion from the employer and upon full and proper information. Unlike the Eight Circuit's approach in *FirsTier Bank*, the DOL finds thus a directed trustee's duty of independent inquiry imperative in the context of participant-directed voting. Under *Carter Hawley Hale* case-law and its subsequent interpretation, the ESOP trustee must examine the participant directed decision to determine whether coercion exists and whether participants received full and proper information regarding the decision. However, this DOL interpretation leaves unclear the extent to which the trustee must evaluate whether the participants' instructions were prudent and for the exclusive purpose of providing benefits under the ESOP.

With respect to unallocated shares – that is, shares held in a suspense account and allocated to beneficiaries as the ESOP repays its loan -, things are less controversial because unallocated shares are considered as belonging to the plan as a distinct collective entity. Commonly, plan documents provide for mirrored voting: they allow trustees to vote unallocated shares (and non-voted allocated shares) in proportion to how plan participants voted their allocated shares. This enables leveraged ESOPs to serve as particularly efficient defensive tools, for they put large blocks of shares

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<sup>23</sup> *FirsTiers Bank, N. A. v. Zeller*, 16 F. 3d 907 (8<sup>th</sup> Cir. 1994).

<sup>24</sup> DOL Op. Ltr. Re : Profit-Sharing Retirement Income Plan for the Employee of Carter Hawley Hale Stores, Inc. (Apr. 30, 1984)

under the manager's control. This technique has, nonetheless, sparked discussion about its compatibility with the fiduciary principles of ERISA. After adopting an earlier firm position against mirrored voting<sup>25</sup>, the DOL has taken a more lenient approach and holds that a trustee should follow a mirror voting prescription, unless doing so would be imprudent and against the best interests of plan participants and beneficiaries.<sup>26</sup> In *Danaher Corporation v. Chicago Pneumatic Tool Company* (1986)<sup>27</sup>, the Southern District of New York Court expressed a view similar to the DOL's earlier position. According to the Court, the trustees must discharge their duties by evaluating the best interests of employees in the abstract as participants and these duties cannot be discharged simply by consulting and carrying out the expressed instructions of those whose present position makes them only the presumptive participants. The Court's reasoning is founded on the arguments that the actual plan participants have no vested right to participate in future allocations, as their participant status is dependent on their employment and that actual beneficiaries had no right to vote on issues which would benefit future participants. In other words, as far as unallocated shares are concerned, the trustee has to evaluate the best interests of plan participants considered as a collective abstract and homogenous entity. In *Reich v. NationsBank of Georgia*<sup>28</sup> which arose in the shadow of a famous takeover contest between Polaroid and Shamrock<sup>29</sup>, the Court delivered a firm judgment against mirrored voting: allowing plan participants, who have an immediate conflict of interest, to act as named fiduciaries of unallocated shares is contrary to ERISA, because there is no way to ensure that present beneficiaries will make tender decisions that are in the best interests of all beneficiaries who will benefit from the plan in the future. So, the trustees have to exercise independent judgment.

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<sup>25</sup> The DOL's view was that voting with respect to unallocated shares is the exclusive responsibility of the plan trustee and that this duty overrides any plan provisions requiring mirrored voting. See, DOL Information Letter, Profit Sharing Plan for Employees of Carter Hawley Hal Stores, Inc. 11 *Pen. & Ben. Rep.* (BNA) 633 (April 30, 1984) ; See also Letter from Alan Lebowitz, Deputy Assistant Secretary for Program Operations, DOL, to ESOP Trustee (Feb. 23, 1989), reprinted in 16 *Pens. Rep.* (BNA), n° 9, 391 (Mar. 6, 1989).

<sup>26</sup> In the letter 'Pass-Through voting in Collectively Bargained Employee Stock Ownership Plans', the DOL states: « a fiduciary must follow a participant's directions with regard to allocated shares unless the fiduciary is able to articulate well-founded reasons why doing so would give rise to a violation of Title I or IV... » [in DOL Op. Ltr. , Sep. 28, 1995 ; reprinted in 22 *Pens. & Ben. Rep.* (BNA) 2249]

<sup>27</sup> *Danaher Corporation v. Chicago Pneumatic Tool Company*, 635 F. Supp. 246, 249 (S.D.N. Y. 1986).

<sup>28</sup> *Reich v. NationsBank of Georgia, N.A.*, 19 E.B.C. (BNA) 1345 (N. D. Ga. 1995)

<sup>29</sup> *Shamrock Holdings Inc. v Polaroid Corp.*, 559 A.2d 257 (Del. Ch. 1989).

In referring to this decision, the Court, in *Herman v. Nationsbank Trust Co.* (1997)<sup>30</sup>, attempted to reconcile the seeming conflict between the DOL and the federal case law. The Court stated that the trustee must comply with the plan provisions except to the extent that following them would be contrary to ERISA by leading to an imprudent decision. The trustees have thus an affirmative duty to investigate whether voting or tendering instructions by plan participants are imprudent.

Despite the divergences between the DOL and the Courts, it should be noted, however, that most relevant tender offer cases have been decided on procedural grounds such as the lack of independent and careful analysis, rather than on the substantial merit of the decision. So, it remains unclear whether a trustee may be held liable for following beneficiaries' instructions that are not in their best financial interests *sensu stricto* but are motivated by considerations related to business exigencies, stability and future of their employer. From this point of view the IRS and the DOL's opinions offer some interesting guidelines. In its General Counsel Memoranda 39870 (hereinafter GCM 39870), the IRS establishes that taking into account non-financial employment factors with respect to the determination to vote or tender ESOP shares violates the exclusive benefit rule of ERISA. The GCM 39870 underlines that both the IRS and the DOL (in a letter to the IRS) have objections to the following provision in the tender offer section of an ESOP: "*the trustee, in addition to taking into consideration any relevant non-financial factors, including, but not limited to, the continuing job security of participants as employees of the company or any of its subsidiaries, conditions of employment, employment opportunities and other similar matters, and the prospect of the participants and prospective participants for future benefits under the plan.*". In its letter to the IRS, the DOL stated that the provision "*if followed by a plan fiduciary would cause the fiduciary to be in violation of Section 404 of ERISA*". This DOL statement is in line with the position that the DOL has taken for a number of years with respect to the compatibility between ERISA and social investing, that is, investments which are directed towards socially and environmentally responsible companies. According to the DOL, non purely financial factors may be taken into account in making an investment decision but only after the investment decision has been validated from a purely financial perspective; investment decisions which are acceptable from a

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<sup>30</sup> *Herman v. Nationsbank Trust Co.*, 125 F. 2d 1354 (11 Cir.1997).

strictly financial perspective can then and only then be evaluated from the perspective of non-financial social investing considerations<sup>31</sup>. This means, for instance, that from two prospective investments determined by the trustee to be strictly equivalent from a purely financial perspective, the trustee may opt for the option that would provide jobs for the union participants in the plan.

This leads us to a third issue which illustrates the poor safeguards provided to ESOP participants with respect to trustees' decisions. It is related to the fact that Courts are unwilling and probably unable to provide substantial standards of conduct when they have to evaluate a trustee decision, be it in the context of takeover or in relation to other fiduciary duty problems, notably the duty of care.<sup>32</sup> Rather, courts tend to confine their scrutiny to compliance with procedural standards and carefully avoid second-guessing trustees' decisions. Indeed, like we said before, as a general rule, the Courts appear to be very reluctant to address the issue of the appropriateness of trustees' decisions and they tend to exculpate trustees for bad or financially unsound decisions when the trustees are able to show care and independence of judgment in the discharge of their duties. If there are no specific requirements under ERISA that there be independent trustees, independent advisors, investment bankers, legal counsel or advisors, the Courts have held that where the interests of fiduciaries irreconcilably conflict with the interests of plan participants, such participants should obtain the benefit of independent legal, financial or investment counsel. This point is aptly illustrated in *Donovan v. Bierwirth*<sup>33</sup>, *Donovan v. Mazzola*<sup>34</sup> and *Donovan v. Cunningham*<sup>35</sup>. However, relying passively on an independent appraisal as such is not always sufficient to shield from fiduciary liability. At the time they engage in a transaction, the fiduciaries must also employ the appropriate methods to investigate the soundness of this transaction. In

<sup>31</sup> See DOL Interpretative Bulletin 94-1, DOL Reg. § 2509.94-1; DOL Op. Ltr. re: Fredrickson Motor Express Corp. (April 14, 1980); DOL Op. Ltr. 80-33A; E. VIEIRA, Jr., "Social Investing: Its Character, Causes, Consequences, and Legality Under the Employment Retirement Income Security Act of 1974" (released by the DOL May 17, 1983).

<sup>32</sup> According to ERISA 404 (a) (1) (B), « plan fiduciaries are required to act with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. ».

<sup>33</sup> *Donovan v. Bierwirth*, 680 F. 2d. 263 (2d Cir. 1982).

<sup>34</sup> *Donovan v. Mazzola*, 716 F.2d 1226, 1231 (9<sup>th</sup> Cir. 1983).

<sup>35</sup> *Donovan v. Cunningham*, 716 F. 2d 1455, 1467 (5<sup>th</sup> Cir. 1985).

Reich v. Valley National Bank of Arizona<sup>36</sup>, the Court held that the trustee of an ESOP violated its fiduciary duties to the plan when it, among other things, relied upon a valuation of the employer securities purchased by the plan which the trustee knew, or through the exercise of a reasonable investigation should have known, was deficient. In this case, the financial expert was not considered as being really independent because he was hired by the firm's management and worked under its supervision. In Howard v. Shay<sup>37</sup>, the Ninth Circuit held that fiduciaries do not satisfy their fiduciary obligations with respect to the valuation of employer securities simply by hiring an independent appraiser to value the securities. Although securing an independent assessment from a financial advisor or legal counsel is evidence of a thorough investigation, it is not a complete defense to a charge of imprudence. The fiduciary must investigate the expert's qualifications, provide the expert with complete and accurate information, and make certain that reliance on the expert's advice is reasonably justified under the circumstances. The Court added that, to justifiably rely on an independent expertise, fiduciaries must make an honest, objective effort to read the valuation, understand it and question the methods and assumptions that do not make sense. Further, if after a careful review of the valuation and a discussion with the expert, there are still uncertainties, the fiduciary should have a second expert review the valuation.

Such a case law shows that procedural due diligence is critical to protect a fiduciary's decision from being overturned. If the fiduciaries have obtained the advice of a competent expert and have sufficiently investigated the various possible options to ensure that they act in the best interest of plan participants, there is almost no risk that the Courts will second-guess their decision.

It is worth noting that the fiduciary issues discussed above apply only to decisions made by the trustees in connection with the operation of the plan (to buy shares, to borrow money) or in connection with shareholder rights pertaining to an ESOP (to vote, to tender, to sell the shares). The decision to establish an ESOP and, except as otherwise provided, the decision to terminate an existing plan are business decisions, pertaining to the sole board of directors of the sponsoring corporation, rather than fiduciary ones. Employers may thus engage in certain activities with

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<sup>36</sup> *Reich v. Valley National Bank of Arizona*, 837 F. Supp. 1259 (S.D.N.Y. 1993).

<sup>37</sup> *Howard v. Shay*, 100 F.3d 1484 (9<sup>th</sup> Cir. 1996).

respect to an ESOP which are not considered fiduciary acts, and so are not subject to the fiduciary protective rules of ERISA. These activities are generally characterized as belonging to the settlor prerogatives, that is, they are under the sole responsibility of the person (or corporation) that has implemented the plan. For example, in *Akers v Palmer*<sup>38</sup>, the Court refused to apply ERISA fiduciary's standards to a company's decision to establish a non-leveraged ESOP, contribute stock to the plan and subsequently terminate it upon the sale of the company.

A fourth and last issue highlighting the poor effectiveness of the protection afforded by the existing law is related to a valuation problem. Unlike other investors, an ESOP typically purchases its stock with a loan obtained from or guaranteed by the plan sponsor (that is, the corporation that has established the plan for the benefit of its employees) and repays the loan with money supplied by the plan sponsor. According to some valuation experts, the fact that the ESOP finances its purchase through a leveraged transaction will have a negative impact on the value of the shares bought by the ESOPs, due to the additional debt incurred by the employer to finance the ESOP's purchase of the shares. The question is then: shouldn't this decline in value be taken into account in determining adequate consideration under ERISA Section 408 (e)? That is to say, should the valuation of the shares purchased by a leveraged ESOP be made with reference to the reduction in value resulting from the leveraged acquisition? As mentioned previously, ERISA § 3(18)(B) defines adequate consideration for the purposes of ERISA § 408(e) as:

*“(i) the price of the security prevailing on a national securities exchange which is registered under Section 6 of the Securities Exchange Act of 1934 or*  
*(ii) if the security is not traded on such a national securities exchange, a price not less favourable to the ESOP than the offering price for the security as established by the current bid and asked prices quoted by persons independent of the issuer and any party in interest.*  
*(iii) in the case of a security not freely tradable, adequate consideration means the fair market value of the security as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and the DOL regulations.”*

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<sup>38</sup> *Akers v Palmer*, 71 F. 3d 226 (6<sup>th</sup> Cir. 1995)

Although, in the third case (iii), ERISA does not define the concept of ‘fair market value’, it generally refers to the price that would be negotiated between a buyer and a seller who are unrelated, under no compulsion to transact, and are able and willing to sell and buy respectively.<sup>39</sup> Applied in the leveraged ESOP context, it appears that if a selling shareholder who is under no compulsion to sell his stock to an ESOP were to negotiate the purchase price for the stock in an arms-length transaction, the seller would not sell its stock for less than its fair market value immediately before the ESOP’s purchase of the stock. The fact that the plan must finance its purchase through a leveraged transaction shouldn’t affect the value of the shares held by the seller prior to the ESOP purchase. The DOL has, however, taken the position in litigation that equity must be allocated on a ‘dollar-for-dollar’ basis<sup>40</sup>. The spirit of this ‘dollar-for-dollar’ position is that employees should receive a benefit from shares equal to the amount paid for them. The resulting consequence is that, for the purposes of determining the prudence of the stock purchase transaction, the ESOP’s fiduciaries should consider the effect of the leverage on the expected value of the stock over both the short and long term. Although the position of the Department is controversial, there is nowadays no authority to support any other valuation approach. One of the big problems with this position is that it is potentially detrimental to workers, especially in the case of workers buyouts. Indeed, if the law prohibits an ESOP from paying the same fair market value that other competing purchasers might pay, ESOP purchasers become second class buyers, eligible only to purchase companies that no one else would buy. Despite the tax advantages connected with an ESOP transaction, it seems unlikely that a seller who would get a price from a prospective buyer would choose to sell to an ESOP for a lesser amount. In practice, practitioners manage to avoid this issue by applying various techniques that we will not mention here. Not to mention the fact that the ‘dollar-for-dollar’ problem does not concern publicly-quoted companies.

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<sup>39</sup> In a proposed regulation, the DOL echoes precisely this definition of adequate consideration: “the price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able as well as willing to trade and are well informed about the asset and the market for such asset.” See Prop. DOL Reg. § 2510.3-18(b)(2)

<sup>40</sup> *Reich v. Valley National Bank of Arizona*, 837 F. Supp. 1259, 1301 (S.D.N.Y. 1993). See also the initiated DOL litigation in *Dole v. Farnum*, 17 BNA Pension Reporter 1494 (D.R.I. 1990).

### III. New directions in ESOP governance.

The American technique of ESOP, while designed to promote worker share ownership, nevertheless doesn't vest any significant management and control rights in the workers' hands. Indeed, its structure emphasizes its value as a corporate finance tool, the lack of control being supposedly compensated by the fact that the tax subsidized plan is theoretically constructed for the exclusive benefit of the employees. Even if an ESOP must be created and managed in the exclusive interests of employees, its very structure fails nevertheless to legally promote (either by statute or by judicial precedent) employees participation in the governance of their shares. Despite the fact that the courts have tried to interpret the fiduciary requirements of ERISA in order to provide the best safeguards possible to plan participants, under the current legal framework, the risk of conflict of interests and management opportunism remains inescapable. They are rooted in the very structure of the ESOP's mechanism itself. As we have seen, several issues illustrate this problem.

- ERISA allows direct representatives of the employers to act as trustee and this is undoubtedly an effective manner to make sure that plan fiduciaries will tend to act with an eye solely to the interests of plan participants, especially in a context where, thanks to fiscal incentives, the company management may instrumentalize ESOPs to realize various corporate strategies.
- The exclusive benefit rule operates as the method of dealing with the issue of representation of plan participants in the plan governance: it is supposed to simply and directly rule out any consideration not clearly in the best interests of plan participants. Moreover, according to the DOL and the Court's interpretation of ERISA, the trustee has a residual paternalistic duty to disregard participants instructions deemed contrary to their financial best interest. This fiduciary perspective presupposes a high degree of unity of interest among plan participants; it does not contemplate separate analysis and action with respect to each beneficiary's interest, but rather a single, collective and abstract evaluation expressed in monetary terms.

- In the takeover context, the judiciary imposes a directed trustee's duty of independent inquiry as imperative in case of participant-directed voting of shares because of the potential conflict between present and future employees' interests. Under the supervision of the court, the management appointed trustee is required to exercise his best judgment about what demands the participants' interest. And, as far as the judicial review of the trustee's decision is concerned, the Courts provide only procedural standards aimed at determining whether the decision is based on a sufficiently accurate and independent expertise.
- Besides the limited participation of plan participants in the governance of ESOP, there is the complete absence of involvement afforded in connection with the adoption and the termination of the plan. Unless the workforce is unionized, an employer can implement a plan unilaterally and unless the plan provisions give employees more control than they typically have, he may terminate the plan unilaterally.

From these observations it could be concluded that ERISA needs some specific and technical adjustment to the fiduciary rules in order to offer better protection to plan participants. However, as Paul Delahaut already underlined 15 years ago, "under the current legal framework, the risk of conflict of interest and self-dealing is inescapable. This risk is rooted in the very concept of the ESOP and the ambiguity of its fundamental purpose, but it is also aggravated by allowing officers of the sponsoring corporation to serve as trustees, or by permitting unrestricted use of leveraging to fund an ESOP."<sup>41</sup>

Besides the opportunity of undertaking specific modifications to ERISA in order to facilitate a better achievement of its protective goal, the question we would like to raise is whether the highlighted difficulties do not emphasize the need for a rethinking, by policy makers, of the ESOPs' governance structure itself to offer employees more say in the management and control of their shares. In other words, how can forms of ESOP governance be developed which engender a better

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<sup>41</sup> P. DELAHAUT, « ESOPs as a Corporate Finance Technique : Possibilities and Limits under ERISA » (1988) 14 *Journal of Pension Planning and Compliance*, 65

participation of the workers-shareholders in the definition and the promotion of their collective interest in ESOP governance?

From this point of view, there exist, nowadays, inside the US system and outside, some interesting institutional alternatives to the patrimonial governance model of ESOPs. These alternatives are distinguished by the fact that they enable workers-shareholders to be represented in the managerial structure of the plans, a type of governance we therefore qualify as 'partnerial', by reference to a form of firm governance quite different from that advocated by the doctrine of shareholder value, where managers act in the sole financial interest of the shareholders. The key idea of this partnerial model, which finds its roots in the work of some French legal theorists<sup>42</sup>, is that intra-firm activity is based on the cooperation between the different stakeholders and that this cooperation aims at a common objective which both synthesizes and transcends the interests of the different constituents. It is not our intention here to make an in-depth study of this partnerial model, nor of the internal mechanism of the partnerial devices used in ESOPs. We would only like to suggest that increasing pluralism on the board of trustees through a system of joint decision-making between workers and employers could be seen as one response to the problems raised by the current ESOPs' shareholder-oriented model.

As far as the US system is concerned, a bill was recently tabled at the 107<sup>th</sup> Congress after the Enron disaster: the "S. 1992 Protecting America's Pensions Act of 2002". Even if, for reasons we are not going to detail, the Congress has officially not passed this legislation, it can be seen as a relevant step in meaningful employee share ownership reform to strengthen workers' rights and protection. Under the S. 1992 Bill, workers are included on the boards of pension plans, including Esops, and help decide what the investment options are in these plans. According to the official Senate Report, *"the Enron debacle makes clear the fact that a pension board formed exclusively of management executives does not provide adequate safeguards to protect the interests of workers. These executives, who had no special training or experience as pension fiduciaries, took no action to ensure the continued prudence of the investment options offered to workers. This is especially startling given the fact that at least some of the management trustees failed to take the necessary*

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<sup>42</sup> See notably, RIPERT, G., *Aspects juridiques du capitalisme moderne*, Paris, LGDJ (1951).

*actions to protect the workers' retirement savings.*"<sup>43</sup> Recognizing that electing worker representatives on pension plan boards is the best way to ensure that pension trustees are accountable, S. 1992 requires that the assets of defined contribution plans with 100 or more participants be held in a joint trust with equal representation of the interests of the employer and the employees. In the case of a plan maintained by a collective bargaining agreement, the employee representatives may be designated by an election process organized by the union. For all other plans, the employee representatives must be elected by the participants pursuant to Department of Labor regulations. Elections of worker representatives can be accomplished with limited expense and organizational capacity. With electronic mail, even companies with far flung offices can easily hold elections. To further strengthen the pension rights of workers, the bill also creates an Office of Participant Advocate within the Department of Labor to help workers facing pension abuse.<sup>44</sup> For readers familiar with the powers of Anglo-American pension plans, this type of arrangement is not inconsistent with the evolution of the trust law, for, in the US, there are many small and medium-sized jointly trusted multi-employer pension plans in industrial crafts such as plumbing, electrical work, and construction trades, not to mention Taft-Hartley pension plans<sup>45</sup>. Today, 65 percent of pension assets in the United States are managed with some form of worker representation on plan boards, and thousands of worker representatives sit on the boards of trustees that govern retirement plans in the public and private sectors. Worker representatives serve on multi-employer pension boards, on the boards of credit unions and public pension funds, and on health and safety committees. State law prescribes a specific role for both active workers and retirees on most funds in the \$2.8 trillion public pension world. In the private sector, more than 3,000 collectively bargained retirement plans

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<sup>43</sup> Protecting America's Pensions Act of 2002, Senate Report 107-226, 107<sup>th</sup> Congress, 2d Session, July.

<sup>44</sup> Today, there is no official advocate to protect workers' pensions and to advocate on behalf of workers with respect to their pension plans.

<sup>45</sup> A Taft-Hartley plan is an employee benefit plan that is managed by a joint board of trustees. The name Taft-Hartley is derived from the Taft-Hartley Act of 1947 (also known as the Labor-Management Relations Act) which made it illegal for an employer to contribute to an employee benefit plan controlled by a Union. For an employer contribution to such a plan to be legal, the Act required that the assets of the plan be held in trust and that the trust be administered by an equal number of employer (management) and employee (Union) trustees.

are jointly managed by workers' and employers' representatives. Some of the nation's largest and most innovative pension plans have worker representatives<sup>46</sup>.

Partnerial forms of ESOPs governance are also present abroad. The most well-known partnerial example is probably the French system which counts as the most advanced of the European Nations in terms of share ownership development. The regulations currently in place in France – which are the outcome of multiple layers of legislative texts that span a forty-year period, established compulsory mechanisms that distance themselves from the one favored by the American model. Employee share ownership funds and employee savings plans are established by collective agreements at the company level. They are controlled and managed through a sophisticated mechanism involving representatives of the employees (trade union), of the employee-shareholders and of the employer. Also, a specific institutional participation of employee-shareholders in the Board of Directors of the parent company is provided for by law as soon as a threshold of 3% of employee shareholding is reached<sup>47</sup>. Lastly, under French law, employees have the possibility to diversify part of their shares and to invest them in funds which are orientated towards 'solidary economic sectors'. In other words, employees have the option to manage part of their investments according to criteria which are not exclusively financial.

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<sup>46</sup> For example, the Teachers Insurance Annuity Association and College Retirement Equities Fund, now known as TIAA-CREF, has elected faculty representatives and may be one of the most successful defined contribution plans in the world. It is the largest defined contribution plan, covering 11,000 institutions of higher education and research. TIAA-CREF fees are low, worker voluntary contributions are high, and investment choices have changed in response to the pressure of the faculty representatives. For more information on labour's governance of pension plans, see T. GHILARDUCCI, "Who Controls Labor's Capital and Why It Matters", Paper prepared for the Second National Heartland Labor-Capital Conference, (1999) Department of Economics, University of Notre Dame; "Small Benefits, Big Pension Funds, and How Governance Reforms Can Close the Gap" in *Working Capital: The Power of Labor's Pensions* (Cornell University Press, 2002).

<sup>47</sup> For a detailed analysis of the French system, see A. AUTENNE, "Employees Financial Participation in the French Legal System", in R. COBBAUT & J. LENOBLE (eds.), *Corporate Governance: An Institutional Approach* (Kluwer Law International, 2003), 185-219. See also, A. AUTENNE, *Analyse économique du droit de l'actionnariat salarié: apports et limites des approches contractualiste, néo-institutionnaliste et comparativiste de la gouvernance d'entreprise*, Bruxelles, Bruylant-LGDJ (2005).

All this does not mean that labor representation on the board of trustees doesn't generate its own problems, if we consider, for instance, the three following possibilities.

- As it is the case with the traditional trustee, there is an unquestionable danger that employees' representatives become captives of the company's management.
- Since a common labor union is one means of coordinating the interests of workers and an Esop association is another, there is a risk of conflict of interests between employees-shareholders' representatives and unions.
- Older workers' representatives may, in effect, usurp policy making. Their interest in early retirement and a high rate of income replacement may not be consistent with younger workers' interest in capital investment and long-term growth.

While these difficulties are important, they are not necessarily insurmountable.

- Regarding the first difficulty, as for the individual trustees, employees' representatives acting as trustees should be held accountable to the final participants: workers should be able to vote regularly on the renewal or termination of their mandate. Another measure could provide that the inauguration or termination of a tax-subsidized Esop could be undertaken only with the consent of a majority of the employees in a vote that meets stipulated procedural requirements. Besides, the legislator could define and mandate some organization in terms less ambitious than those defining unions charged with co-ordinating the exercise of share voting rights (perhaps an elected workers' council).
- The second difficulty could be dealt with by drawing inspiration from the policies of some European countries – most notably France - where there is an explicit link between the institution of collective bargaining or co-determination and the institutions of share ownership governance. The close relationship between financial participation and the collective bargaining process ensures benefit standards and contribution rates consistent with the wage market; in this respect employee share ownership can be seen as an

integral element of the social market much admired by some US commentators.

- One response to the third problem is to try to smooth out differences in shareholdings in the employing company by permitting or requiring senior employees to diversify their shares. This responds to the relatively greater risk aversion of the senior workforce but also limits the inequality in shareholdings in the sponsoring firm.

#### **IV. Conclusions**

In this study of Esops governance in public companies, we have seen that the institutional configuration of Esops conveys an affiliation to a governance logic termed “patrimonial”.

Four elements have been particularly revealing of this orientation.

Esops are governed by a set of rules located within the regulatory framework of ERISA and inspired by trust law. Being partly assimilated to pension or welfare plans, Esops are deeply influenced by the regulatory logic prevailing in this field and which is founded on mainstream finance theory. Modern Portfolio theory and the efficient markets hypothesis are essential reference points for ESOPs trustees investment decisions.<sup>48</sup>

The interests of the plan participants are evaluated and expressed in financial terms through the exclusive benefit rule. This rule, which is at the heart of ERISA’s fiduciary duties, requires that the plan trustees discharge their duties solely in the interest of the plan participants and for the exclusive purpose of providing benefits to them. According to the US Labor Department interpretation of the law applicable to ESOPs as well as the Courts’, it simply and directly rules out any consideration not clearly in the best financial interests of plan participants.

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<sup>48</sup> Even if trustees do not always act in accordance with these theoretical propositions, the language of decision making is impregnated with related terms and concepts. For a thorough analysis, see G. CLARK, *Pension Fund Capitalism*, Oxford University Press (2000).

Esops participants are not really treated as full-fledged owners and even full-fledged ownership rights to capital carry very limited control rights. Plan trustees have a duty to ignore plan participants instructions when they believe them to be patently contrary to their financial interests.. As Hunter Blum points out: « *The underlying contradiction of the leveraged Esop is that it must exist for the exclusive benefit of the employees. Yet its very structure emphasizing its value as a corporate finance tool, contradicts the exclusive benefit rule.* »<sup>49</sup>

Esops law affords a very limited participation of plan participants in connection with the adoption, management and termination of the plan. As far as management is concerned, plan trustees – because they depend upon patrons for their appointment – reflect the interests of their employers, even if those interests are legally irrelevant to their fiduciary obligations.

Being skewed towards the maximization of financial value, ESOPs ill serve their intended purpose as a means of involving employees in ownership of their firm. Although, on the surface, it looks as if ERISA's fiduciary provisions are the ultimate solutions to further this goal, the individual workers are in fact poorly equipped to ensure that the plans are managed for their own benefit. Employers may turn the financial gains towards the realization of financial objectives (such as raising new capital) or managerial strategies (such as fending off unfriendly acquirers) that are potentially detrimental to the workers' interests.

Besides the punctual technical changes that are suggested to ameliorate the effectiveness of compliance by plan trustees with their duties towards the participants, it seems to us that there is a need for a more systematic consideration of the institutional organization of plan governance itself. To illustrate, specific attention has been paid to forms of governance in which the employees have a say in

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<sup>49</sup> H. C. BLUM, « ESOP's fables : Leveraged ESOPs and their Effect on Managerial Slack, Employee Risk and Motivation in the Public Corporation » (1997) 31 *U. Rich. L. Rev.*, 1539. In the same vein, Henry Hansmann notes: "*In many firms with ESOPs the workers, through the ESOP, have a claim on most or sometimes all, of the firm's net earnings while control over the firm remains in other hands. These firms are often described as 'worker-owned' but this is a bit of a misnomer. In such firms, control is in the hands of investors of equity capital who also receive a share of the firm's residual earnings; firms of this type are essentially investor-owned firms with incentive compensation schemes*" in Henry HANSMANN, "When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination and Economic Democracy" (1990) 99 *Yale Law Journal* , 1757.

the control and management of the shares held in the ESOPs trust, mainly through a system of joint decision-making between workers and employers' representatives on the board of trustees, a type of governance we have termed "partnerial". Whether a 'pluralisation' of the board of trustees will resolve all of the difficulties encountered in the operation of ESOPs, remains to be seen. But, interesting examples exist nowadays, be it inside the US legal system or outside, and which deserve consideration for policy makers involved in employee share ownership and pension fund reform in the current context of the post-Enron debates.<sup>50</sup>

In conclusion, the issues highlighted in this article open up a new and promising field of research in corporate governance which focuses on the following question: which form of ESOP governance should we put forward so as to place greater emphasis upon employees-shareholders' control of their assets while avoiding the side-effects of greater pluralism on the board of trustees? It is, in the words of the French authors Beffa, Boyer and Touffut, "the coherence of the mode of regulation that is at stake, that is to say, the acceptance of modern forms of finance by the employees, their organizations and public opinion."<sup>51</sup>

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<sup>50</sup> The Enron case did not involve an Esop but a 401(k). A 401(k) Plan is a defined contribution plan that is a cash or deferred arrangement. Employees can elect to defer receiving a portion of their salary which is instead contributed on their behalf, before taxes, to the 401(k) plan. Sometimes the employer may match these contributions. It is similar to the English 'contracted out money purchase plan'. The 401(k) plan of Enron was heavily orientated towards internal shareholding. In other words, thanks to the rapid rise of the stock prices during the 1990s, Enron employees had their 401(k) portfolios heavily skewed in Enron stock (according to the Employee Benefit Research Institute, almost 58 percent of the assets of Enron's 401(k) plan was invested in company stock).

<sup>51</sup> J-L BEFFA, R. BOYER, J-P. TOUFFUT, "Les relations salariales en France: Etat, entreprises, marchés financiers ", (juin 1999) *Notes de la Fondation Saint-Simon*, n°107, 48.