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Corey Rosen is the founder of the National Center for Employee Ownership, a nonprofit membership, research, and information organization. Previously, he worked as a staff member in the Senate and taught political science at Ripon College in Ripon, Wisconsin.

In this article, Rosen argues that almost all participants in employee stock ownership plans fare better than employees in other retirement plans (not to mention most working adults who are in no retirement plan at all). He concludes that although some proposed reforms make sense, stricter standards would eliminate many ESOPs, and protect only a small number of employees from abusive transactions.

In an April 23 article for *Tax Notes*,[1] William K. Bortz argued that employee stock ownership plans, especially those in closely held companies, are saddled with a set of interrelated problems and badly need reform.

An ESOP is a type of retirement plan and is thus governed by ERISA. In an ESOP, a company sets up a trust that is required by law to invest primarily in the employer's stock. The trust can be funded by direct contributions of company stock or periodic cash contributions used to buy shares. However, unlike other retirement plans, the ESOP can also borrow money to buy stock. This enables the ESOP to buy large percentages of the company all at once and repay the loan over time using company (not employee) contributions. Unlike 401(k) plans, which are mostly funded by employees, ESOPs are usually entirely employer funded.

Congress conferred several tax benefits on ESOPs that go beyond the normal tax deductibility of employer contributions and deferred taxation for employees. Most notably, in C corporations, once the ESOP owns 30 percent of all the shares in the company, sellers to the ESOP can reinvest the proceeds of the sale in other securities and defer any tax on the gain. Also, the profits attributed to an ESOP's ownership in an S corporation are not taxed, so a 100 percent S corporation ESOP pays no federal income tax (but employees eventually pay tax on the distributions that embed the resulting gains in their stock value).

The latest data from the National Center for Employee Ownership (NCEO), a nonprofit research, information, and membership organization, show that there are about 7,000 ESOPs and 2,000 plans that while technically not ESOPs, function much like them. Taken together, these plans cover about 14 million participants and hold more than $1 trillion in assets. More than 90 percent of companies with ESOPs are closely held, though some of those companies are very large. However, most of the assets and employees in ESOPs are in public company plans.

Bortz has many concerns. He points out that the stock in ESOPs has to be appraised and that the company often has a role in choosing the appraiser, which can lead to the selection of unqualified appraisers. Second, he mentions that employees have only limited voting rights (the law requires them to vote on a few issues, such as the sale of all or substantially all the assets of a company, but there is no requirement that employees vote to elect the board). Finally, Bortz says the law allows a time lag before cash payouts from ESOPs must begin and does not guarantee that the money will be there to make the payments.

These arguments deserve consideration, but before leaping to conclusions, we should look at what the 41 years of experience with ESOPs tells us about how they affect the retirement security of employees. Fortunately, there is a wealth of actual data to do so. The overwhelming conclusion of this research is that an employee is far better off being in an ESOP than not being in one. While there have been instances in which ESOPs have been seriously abused, the kinds of reforms Bortz suggests would result in far fewer ESOPs being created. If enacted, there would be a sharp reduction in the number of new plans. The remaining plans might be somewhat more secure than plans are now, but the cost would be that millions of employees never get the substantial benefits that an ESOP can provide.

[1]William K. Bortz, "The Problem With ESOPs," *Tax Notes*, Apr. 20, 2015, p. 327.

A. The Data on ESOPs and Retirement Security

As Bortz notes, ESOPs inherently increase the concentration of retirement assets in a single security — company stock — and critics contend that this reduced diversification makes ESOPs too risky. Even worse, the argument goes, employees depend on the same company for both their paychecks and retirement accounts.

This is an understandable concern, but it rests on an assumption that turns out to be incorrect in most cases. The diversification argument often assumes that companies with ESOPs are substituting the ESOP for a diversified retirement plan. That turns out to be not true. ESOP companies are slightly more likely to have a secondary retirement plan (even a defined benefit plan) than non-ESOP companies are to have just *one* plan. Moreover, many mature ESOPs begin to diversify the assets in the plan over time, as explained below. So in the large majority of cases, the real comparison is between non-ESOP participants who have $X in diversified assets, versus ESOP participants who have $X in diversified assets but also $Y in company stock. In practice, regarding retirement assets, ESOP participants are better off than people in other retirement plans by a considerable margin, and they are vastly better off than workers who have no retirement plan at all.

By their design, ESOPs are better for lower-income and younger employees than are typical 401(k) plans. Most of the money in 401(k) plans comes from the employee, not the employer. Lower-income employees are the least likely to participate in a 401(k) plan, and they contribute the lowest percentage of pay. The Employee Benefit Research Institute found in 2013 that among private sector wage and salary workers between 21 and 64, just 52.7 percent had access to any kind of retirement plan, and only 45.4 percent actually participated in one. For workers making less than $40,000 per year, the numbers are even lower.[2] Because lower-paid people who do participate contribute a lower percentage of their pay to the 401(k), they also get a lower match on a percentages basis, thus skewing 401(k) benefits upward. The EBRI data indicate that those making more than $80,000 per year contribute between 8 and 9 percent of pay per year to the 401(k), while those making $40,000 or less contribute 4 to 6 percent.[3]

By law, ESOPs must at least include all full-time employees over age 21 in the plan and must base their stock allocations on relative pay up to a maximum of $265,000 (in 2015) or use a more level formula. Thus, the plans include almost everyone and do not skew contribution rates toward higher-income people.

ESOPs also prove to be better than 401(k)s in several other ways, as described below.

1. ESOP company contribution rates are higher. Non-ESOP companies contribute about 4 percent of pay per year into their 401(k) plans, according to the 401(k) Plan Help Center, but that only goes to those employees who defer income into the plan, which typically constitutes about two-thirds to three-quarters of the eligible employees. As shown below, ESOPs are not actually more volatile than 401(k) plans, but even if they were, there is considerable room for downside in an ESOP before the risk becomes comparable with that of a diversified plan.

In 2010, the National Center for Employee Ownership (NCEO) did an extensive analysis of 2009 ESOP filings using data from Department of Labor (DOL) Form 5500 reports. The study carefully compiled data from multiple plans within a single company. This was not just a sample; the NCEO looked at every ESOP company (for which data was available) and compared ESOPs with all other retirement plans. The average ESOP company contributed $4,443 per active participant to its ESOP in the most recently available year. In comparison, the average non-ESOP company with a defined contribution plan contributed $2,533 per active participant to its primary plan in that year. In other words, ESOP companies contributed 75 percent more on average to their ESOPs than other companies contributed to their primary defined contribution plan. Controlling for plan age, number of employees, and type of business, the ESOP advantage increased to between 90 and 110 percent more than non-ESOP companies.[4]

2. ESOPs are more likely to have secondary retirement plans than other companies are to offer any plan. In that same 2010 project, the NCEO found that 56 percent of ESOP companies had a secondary retirement plan, but only 47 percent of non-ESOP companies offered any kind of retirement plan. In other words, ESOPs are not a substitute for other retirement plans.

3. ESOPs and ESOP participants often diversify over time. Once ESOPs have bought all the shares they are going to buy, companies often start to put cash into the plan. In mature ESOPs, often 20 percent or more of the assets are cash. By law,

[2] EBRI, "Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2013" (Oct. 2014).

[3] EBRI, "Plan Demographics, Participants' Saving Behavior, and Target-Date Fund Investments" (May 2009).

[4] NCEO, "Research on Employee Ownership, Corporate Performance, and Employee Compensation" (2015).

employees with 10 years or more in the plan who are age 55 or older can diversify up to 25 percent of their company stock. Five years after they start doing this, they can diversify up to 50 percent.

4. ESOPs are less volatile and have better rates of return. Data from the DOL for retirement plans with 100 or more participants show that ESOPs outperformed 401(k) plans in 15 of the 20 years between 1991 and 2010 and underperformed in only three (two were the same). ESOPs were also less volatile during that time, as measured by standard deviation scores for the periods analyzed by the DOL: 1991-2000, 2001-2010, 2006-2010, and 2008-2010.

The table below provides a summary of the findings:

Return Rates and Volatility in ESOPs Versus 401(k) Plans

Measure	401(k) Plans	ESOPs
Mean rate of return	7.8%	9.1%
Standard deviation		
1991-2000	11.2%	11.1%
2001-2010	13.5%	12.4%
2006-2010	15.5%	14%
2008-2010	19.3%	17%

Source: Private Pension Plan Bulletin Historical Tables and Graphs, Department of Labor Employee Benefits Security Administration, Nov. 2012.

There are two reasons why ESOPs have better return rates and less volatility than 401(k) plans. First, almost all ESOPs are in closely held companies. By law, privately held ESOP companies must undergo an annual independent appraisal. The appraisal typically projects earnings over the next three to five years and then calculates a risk-adjusted present value to use as the key element of valuation. This technique tends to average out future volatility. Second, closely held ESOP companies tend to be managed for the long term because their management does not need to worry about shareholder pressure for short-term results. Equities in 401(k) plans are typically in public companies, in which quarter-to-quarter performance is key. As we have seen in the last two decades, the stock market can be extremely volatile, partly as a result of this pressure.

5. ESOPs lay people off less than do conventional companies. Comparing retirement benefits is of no value for those who don't have jobs. General Social Survey data from 2002, 2006, and 2010 indicate that employee ownership plan participants are one-third to one-fourth less likely to be laid off than are employees who are not in employee ownership plans.

6. ESOPs default on loans at a very low rate. If the argument is true that ESOPs are being overvalued and put employee assets at excessive risk, there should be a high default rate for ESOPs that borrow money (as most do). However, in an NCEO study of 1,232 leveraged ESOP transactions at three large banks, only 1.3 percent of the ESOP companies defaulted in a way that imposed losses on their creditors for loans in effect between 2009 and 2013 (making the annual rate of default a little more than 0.2 percent). The defaults accounted for 1.5 percent of the total value of the ESOP loan portfolio for these companies during this period.[5]

In a parallel study, the NCEO asked 40 ESOP appraisal firms to provide data on defaults among the ESOP companies they appraised between 2009 and 2013. Eighteen firms responded and reported data on 845 companies. Of these, nine companies (1.1 percent, or an annual rate of 0.2 percent) defaulted in a way that imposed losses on their creditors, while 26 (3.1 percent, or an annual rate of 0.6 percent) had to restructure their loans but went on to repay or were currently repaying their loans. The reason why ESOP companies have a lower default rate is that they perform better. Multiple studies show that ESOP companies have stronger performances after establishing the ESOPs than before.[6]

7. The bottom line. In the analysis of the Form 5500 data discussed above, the NCEO concluded that when looking only at defined contribution plan assets contributed by the company, ESOP participants have approximately 2.2 times as much in their accounts as participants in comparable non-ESOP companies with defined contribution plans. The ESOP participants are somewhat more likely to participate in a 401(k) plan or other retirement plan as well.

B. So Are Reforms Needed?

Bortz and other critics of ESOPs argue that all ESOPs should have independent outside trustees. In 2012 the NCEO surveyed ESOP companies and found that 37 percent had outside trustees. If not an outsider, the trustee is almost always a corporate officer (but very rarely a corporate officer who has sold to the ESOP). The law requires all trustees, whoever they are, to act for the primary benefit of plan participants, but conflicts can arise if corporate insiders are trustees. Both the DOL and plan participants can and do sue when they believe this duty has been violated, but abusive transactions still occur.

Requiring independent trustees would eliminate many of the conflicts, but this is a significant added

[5] NCEO, ''Default Rates on ESOP Loans, 2009-2013'' (2014).
[6] *Id.*

cost for smaller ESOP employers. Also, many business owners are reluctant to turn over potential control of their businesses to outsiders. Trustees vote the shares in an ESOP and could, in theory, remove or sue a board. These concerns over cost and control would lead to far fewer ESOPs.

Bortz argues that appraisers should be experienced professionals in the field, and there can be no argument there. However, neither the DOL nor any of the valuation professional associations has been able to define what that would mean. The DOL has never issued regulations on how ESOP appraisals should be performed and tested. Doing so would be a valuable step welcomed by all parties in this debate.

But just how serious are valuation issues? One way to look at this is to consider how many ESOPs have ended up in court on this issue. The NCEO has been tracking all ESOP litigation since 1990.[7] Over that period, 26 cases have gone to trial. Of course, settlements can occur before a court decision, sometimes with the DOL. There is no way to count these settlements, but the NCEO estimates that as many as 20 are reached annually before trial. Given that there are 7,000 ESOPs, this is a very small number. As discussed earlier, valuations that are excessively aggressive should result in a high loan default rate, but the default rate is extremely low. Bankers love ESOPs.

Another common reform proposal is to require that employees be able to vote their shares to elect the board. About 15 percent of privately held ESOP companies already do this in some way or another. Talking with these employers, I have found that they all say that this voting power has not changed much about the constitution or function of the board — employees rarely want to be involved at that level. Employees instead care a great deal about how much say they have over their work. While the research shows that companies perform better when they give employees more of this type of control, there is no way to construct a legal requirement for high-engagement management.

However, the main concern regarding employee voting power is the impact it would have on ESOP formation. Few things would be more discouraging than telling an owner who has built a business and wants the employees to own it — rather than sell it to someone else (often at a higher price) — that employees can now control the business. Many of these owners sell only part of their shares to the ESOP initially and wait until later before selling more. Others sell all their shares but maintain some role in the company and often help finance the transaction by taking a note. Requiring voting rights would be a huge barrier for many of these owners.

A final issue is whether participants should receive payouts sooner than they currently do and whether the law should require security to guarantee the payment. The reason the law allows delayed payouts (up to six years after termination other than for death, retirement, or disability) is that the delay allows companies to more effectively manage cash flow so that the ESOP remains a benefit for employees over the long term. NCEO surveys show that more than half of all ESOPs voluntarily pay out sooner than required. As with independent trustees, a stricter rule would result in fewer plans being formed or would force existing ESOPs to sell to an outsider to handle repurchase.

There are companies that go bankrupt or come close to it, leaving employees with little or nothing (though the data show this to be very rare). This is indeed a problem, but it is hard to imagine a solution. In theory, companies could be required to buy insurance to protect against that event, but that would be extraordinarily expensive and hard to find. (The insurance companies I have asked say they would not offer it.) Another alternative is to find a hedge against the company stock, but this would also be hard to accomplish and would be very expensive. These costs would eat into the returns for ESOP participants in all companies.

C. Conclusion

Bortz and other critics are correct that there are ESOP disasters. It is easy in theory to construct a series of reforms that would prevent many of them, albeit the only way to eliminate the risk inherent in ESOPs is to eliminate ESOPs. The question a policymaker must address is whether these reforms would cut down on the large number of ESOPs that currently exist — of which only a small number produce very bad results — and consequently leave only a small number of ESOPs that meet the higher standards. The losers in this process would be the millions of employees who now have far better retirement packages than they ever would have had absent an ESOP.

Years ago I worked on Capitol Hill, and before that as a political scientist studying Congress. The legislative process — especially regarding anything involving tax incentives — is invariably a trade-off between rules that are so strict that few people want to use them and so lax that they produce more harm than good. Some change in ESOP rules would be welcome, especially more guidance on valuations. However, the extensive research data are clear: ESOPs have done far more good than harm.

[7]NCEO, *ESOP and 401(k) Plan Employer Stock Litigation Review 1990-2014* (2014).