Split personality: an ESOP is a retirement plan. No, it's an ownership investment. Wait—it's neither one - Benefits

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IN THE WAKE OF THE SPECTACULAR BANKRUPTCies of Enron, United Airlines, and Polaroid, employee stock ownership plans have come under intense media scrutiny during the past year. The staggering losses of employees' retirement savings have prompted pundits to predict the demise of ESOPs, and politicians to call for regulatory overhaul.

Pundits notwithstanding, ESOPs won't disappear anytime soon. While the total number of plans has indeed declined in recent years--from 11,500 in 2000 to 10,000 in 2002, according to the nonprofit ESOP Association--private-company plans have increased as a percentage of the total, from 90 percent private in 1997 to between 95 and 97 percent private in 2002.

Experts say the decline in the number of total plans is the result of changes to tax laws governing public-company ESOPs, and of the increased use of alternative methods of delivering equity into employee hands, like stock options.

On the other hand, reasons for the private-ESOP increase include the current depressed market for initial public offerings, business combinations, and partial-interest sales, which means there is a dearth of exit strategies for private owners.

"Almost every ESOP I've ever done has been done after the owner tried to do an IPO or a strategic sale," says Vaughn Gordy, senior vice president and trust officer of LaSalle Bank NA, in Chicago. "Something doesn't go right, so instead they try an ESOP. In fact, I've got more proposals outstanding [for ESOPs] right now than I ever have."

Also behind the private-ESOP surge are the challenges that small public companies face complying with the corporate-governance and reporting rules of the Sarbanes- Oxley Act of 2002. Many may choose instead to go private using an ESOP, says Gordy. ESOPs are also a particularly viable business model when the company converts to an S corporation. Finally, an ESOP remains a potentially effective vehicle for building employee wealth. For example, at Appleton, a coated-paper manufacturer in Appleton, Wisconsin, employee-owners have seen the value of their stock double since 2001, according to CFO and vice president of finance Dale Parker (see "The Private Face of ESOPs," page 75).

But if ESOPs are in no danger of dying, they do need immediate medical attention. The disasters at Enron and elsewhere have underscored their fundamental conflicts--and risks.

The most obvious conflict resides in an ESOP's basic structure. Because they are covered under the Employee Retirement Income Security Act of 1974, ESOPs are considered retirement vehicles. Under ERISA requirements, the trustee (or trustee committee) must manage the plan for the sole benefit of the members and to preserve the value of the plan assets. But this flies in the face of the plan's mandate: to invest solely in the shares of a single company.

Such a nondiversified, high-risk portfolio is considered the worst possible design for a retirement vehicle--a fact that was made clear as State Street Bank and Trust Co., the ESOP trustee for both United and Polaroid, dumped the companies' nearly worthless shares as they neared insolvency (see "What's Wrong with This Picture?" January). Plan experts say ESOPs should never be the sole retirement vehicle for employees, and in ESOP-owned companies they usually aren't (see chart, page 73). But this doesn't resolve the fundamental conflict.

OUT OF CONTROL In addition, the notion that an ESOP creates employee owners maybe misleading, and is still an unsettled issue. Some experts say, al though employees in ESOPs are considered "beneficial owners" of the stock, they have limited control over how that stock is voted. Only the trustee is authorized to vote the ESOP shares (although there are a number of exceptions to that rule, and plans can stipulate circumstances under which the employees can vote stock).

Thus, the final decision on the disposition of shares can fall to the trustee, which may or may not do as the ESOP members direct.

This was the case in both the Polaroid and United ESOPs, in which plan members vehemently protested the trustees' decision to sell shares, arguing that it was crucial that the employees maintain some ownership stake to have a voice during bankruptcy proceedings.

"The employees valued their ownership stake more than the stock value in these cases, but the fiduciary didn't," comments J. Michael Keeling, president of the ESOP Association. And there are experts who claim the trustee's mandate--to preserve plan assets--legally trumps all other considerations, including an employee's desire to maintain ownership of the stock.

"We work very hard to make employee--owners feel like they have an ownership role," says LaSalle Bank's Gordy. But in reality, they have less control over what happens to their stock--and the company--than a regular shareholder, who can at least vote or sell his stake. On the other hand, says Gordy, it's unlikely that a company shareholder would get the courtesy of a returned phone call from a member of the board of directors. When Gordy, whose bank is the trustee of ESOPs at more than 40 companies, calls a director on behalf of employee shareholders, he always gets a call back.

Another fundamental conflict of ESOPs came to light in the Polaroid and United cases: trustees at both companies effectively terminated the ESOP by selling its shares. "As share value goes south, suddenly the trustee becomes the decision maker about whether or not you have an ESOP' says Keeling. "Terminating a plan should be a management decision; it's not a trustee decision." However, given the troubles the Enron plan trustees encountered when they failed to liquidate the ESOP as the company skidded toward bankruptcy, trustees are now more likely than ever to sell ESOP shares if things look bad.

The conflicts don't end there. Once a company is in bankruptcy, the desires of company creditors, the company itself, and ESOP shareholders often directly clash. United creditors and executives tried to block State Street, the United trustee, from selling ESOP shares after the company declared bankruptcy--partly because United feared a change of control, partly because it needed ESOP-related tax breaks for its postbankruptcy success. The Internal Revenue Service eventually decided to extend the tax breaks even if the ESOP was sold off, and the shares were sold. However, the issue was not resolved through a court ruling, so the same crisis could easily repeat itself at another troubled ESOP-owned company.

SOME THERAPY NEEDED Many experts think the time is right to reconsider whether ESOPs should fall under ERISA, given that their dual goals--preserving retirement benefits and holding an ownership position--are in conflict over the long term. After all, despite the conflicts, research has shown that ESOP-owned companies are more productive, pay higher wages, and offer better overall benefits than their non-ESOP-owned peers. Given this track record, ESOP creation should be encouraged.

In 1985, President Ronald Reagan recommended removing ESOPs from ERISA, a decision that Keeling and the ESOP Association accepted as long as some of the basic concepts, like corporate tax breaks and vesting schedules, were preserved. But Congress blocked the move. Now the issue is back on the table. In April, Rep. Cass Ballenger (R-N.C.) proposed HR 1778, which calls for a Presidential Commission on Employee Ownership to review the inherent conflicts and regulatory and policy positions of federal agencies that often hinder the creation of more ESOPs.

Keeling, for one, thinks something needs to be done. "If employee ownership is going to increase," he says, "the conflict issues have to be addressed." And until they are, it's important that companies rolling out ESOPs make sure that employees are made very well aware of the split-personality nature of such plans.

SHARING THE WELTH

Percentage of closely held companies having other retirement plans

	ESOP Cos.	Non-ESOP Cos.
Defined Benefit Plans	20.1%	4.9%
401(k)	33.3	6.2
Non-401(k) Profit Sharing	35.7	8.0
Other Defined Contribution Plans	14.7	2.3

Source: 2001 study by Douglas L. Kruse and Joseph R. Blasi, School of Management and Labor Relations, Rutgers, University

RELATED ARTICLE: The Private Face of ESOPs

PUBLIC-COMPANY EMPLOYEE STOCK OWNERSHIP PLANS boomed in the mid-to-late 1980s, often as a defense against hostile takeovers. Today, an ESOP is much more likely to look like the plan that owns 100 percent of Appleton, a coated-paper manufacturer in Appleton, Wisconsin.

Created in 2001, the Appleton ESOP involves about 2,500 employees. They voluntarily transferred their diversified 401(k) assets into a trust that bought all of the company's stock from the parent company, UK-based AWA. "Our parent company had made it clear that they wanted out of our business, and they were going to just run the company for cash, then liquidate it or sell it to a financial buyer," says CFO and vice president of finance Dale Parker. "We weren't thrilled with that. We wanted to grow a company."

The amount of company stock given to each employee was determined by the dollar value of his or her 401(k). The stock is valued independently twice a year, and employees can continue to divert a portion of their pay to acquire more stock. They may withdraw the funds on retirement or when they leave the company. New employees are also issued stock, and although this dilutes the ownership stake of current owners, Parker says there's a reason the plan was designed that way.

"We decided when we formed the ESOP that we didn't want a class of employees who were owners and a class who weren't," he explains. So far the company's employee-owners--9 out of 10 of the company's employees chose to participate--have seen the value of their stock increase by 100 percent.

S CHANGE

Appleton's ESOP is especially viable due to a change to the tax laws in 1998 that allows ESOPs to hold stock in S corporations (which can choose to distribute all pretax profits directly to shareholders). This change, coupled with a rule that exempts all ESOPs from paying federal income tax on profits, has enabled ESOPs that own 100 percent of the equity of an S corporation--like Appleton--to avoid paying any federal income tax. (An ESOP is considered a single shareholder.) This makes the ownership proposition an outstanding financial model, says Parker.

In the past five years, the S-corp ESOP has become the single most popular type of ESOP overall among the members of the ESOP Association, says president J. Michael Keeling. Seventy percent of the association's members are S-corp ESOPs. But unlike Appleton's plan, most ESOPs are leveraged and do not involve a transfer of retirement-plan assets, according to Jim Waldo, head of the national corporate finance practice at Houlihan Lokey Howard & Zukin's Washington, D.C., office.

In a leveraged ESOP, a company obtains a loan from a bank or other capital source to buy the stock, says Waldo. The parent company makes tax-deductible contributions to the ESOP to enable it to pay back the loan amounts, and shares are released incrementally to employees as the loan is paid off. Hence, the leveraged ESOP is more like a straight benefit than the plan-to-plan-transfer ESOP at Appleton.

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