
SAFEGUARDING EMPLOYEE STOCK OWNERSHIP PLANS: INSURANCE AS ASSURANCE

Lauren E. Berson & Nicholas L. Cushing***

INTRODUCTION

When Jimmy Allen began working for United Airlines in 1964, he was only twenty-two years old.¹ Allen assumed that his career as a pilot, “the best-paid of rank-and-file United workers,”² would allow him to retire comfortably.³ Forty-one years later, Allen, who flew for United for thirty-eight years, learned that he will not be able to live quite as well as he had hoped.⁴ With United looking to hand its pension plans off to the Pension Benefit Guaranty Corporation (“PBGC”), Allen faced close to a 70% reduction in his retirement benefits.⁵

Because of these reductions, Allen was forced to sell his home in Colorado Springs, Colorado and buy a smaller house near Philadelphia,

* Lauren E. Berson is an associate with Ernst & Young’s Transaction Advisory Services, Transaction Tax practice in New York, New York. She received her J.D. from Hofstra University School of Law and M.S. and B.B.A. from the Frank G. Zarb School of Business at Hofstra University. The opinions expressed in this Article reflect the personal views of the authors and do not necessarily reflect the opinions of Ernst & Young, Hofstra University, or its faculty. A special thank you to Marshall Tracht for all of his help and support in the writing of this Article.

** Nicholas L. Cushing is an associate at Krusch & Sellers, P.A. in Charlotte, North Carolina. He received his J.D. from Hofstra University School of Law and his B.S. from Minnesota State University Moorhead. The opinions expressed in this Article reflect the personal views of the authors and do not necessarily reflect the opinions of Krusch & Sellers, Hofstra University, or its faculty.

1. David Kesmodel, *Possible \$100,000-a-Year Loss Prompts Lifestyle Changes*, ROCKY MTN. NEWS, Dec. 25, 2004, at 6C.

2. *Id.*

3. *See id.*

4. *Id.*

5. *Id.* Allen has been receiving a pension of about \$144,000 a year (\$12,000 a month), but the PBGC payments to individuals are capped by Congress, meaning that Allen’s pension will probably be reduced to about \$40,000 per year. *Id.*

Pennsylvania—a move that reduced his housing costs by half.⁶ Adding insult to injury is the fact that Allen “lost his shirt” in United’s Employee Stock Ownership Plan (“ESOP”).⁷ The problems began in 1994, when Allen agreed to wage cuts in exchange for stock in United’s parent company, UAL Corp.⁸ By his estimation, Allen figures that the 6,400 shares of stock that he received cost him about \$260,000 in forgone income.⁹ Although the stock was “worth more than \$600,000 on paper . . . at [its] peak in 1997,” the shares could not be sold until their owner retired or left the company.¹⁰ When Allen finally did retire in 2002, he sold the stock, for which he received a meager \$25,000.¹¹ Was there a way for United to ensure that the ESOP would provide workers with a more secure future? The proposal and ideas in this Article will seek to address that timely issue and suggest a measure that will prevent employees and their ESOP benefits from meeting the same demise as their ill-fated employer.

“There are two levers for moving men: interest and fear.”
—Napoleon Bonaparte¹²

In the current state of retirement benefits, employees too are moved by interest and fear—interest in the security and permanence of their retirement benefits and fear that another debacle of Enron-proportions could rob them of their hard-earned future support. In 1974, Congress passed the Employee Retirement Income Security Act¹³ (“ERISA”) to safeguard pension plans and create a set of rules which would guarantee the economic security of the aging workers of our society and the economic well-being of our workforce as a whole.¹⁴ However, with a statutory scheme that protects some retirement plans and not others, our

6. *Id.*

7. *Id.* See generally discussion on ESOPs *infra* Part III (discussing the risks associated with ESOPs).

8. Kesmodel, *supra* note 1.

9. *Id.*

10. *Id.*

11. *Id.*

12. QuoteWorld.org, Napoleon Bonaparte Quotations, <http://www.quoteworld.org/authors/napoleon-bonaparte> (last visited Jan. 20, 2009).

13. Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at §§ 1-4402, 29 U.S.C. §§ 1001-1461 (1974)).

14. See *Moench v. Robertson*, 62 F.3d 553, 560 (3d Cir. 1995) (quoting *Cent. States, Se. & Sw. Areas Pension Fund v. Cent. Transp., Inc.*, 472 U.S. 559, 570 (1985) (“Congress enacted ERISA in 1974 . . . set[ting] out to ‘assur[e] the equitable character of [employee benefit plans] and their financial soundness.’”)).

workforce is becoming more and more motivated to press for change, push for protections of their rights and money, and perforate the preconceived notion that all retirement benefit plans are created equal.

ESOPs are just one of a number of categories of retirement plans that fall within the confines of ERISA.¹⁵ ERISA provides certain benefits, protections, and guarantees for these retirement plans, as per an extensive statute detailing the intricacies, allowances, and prohibitions regarding each type of plan.¹⁶ However, ESOPs, while broadly governed by ERISA, are subject to a different set of rules and analysis from all other retirement plans.¹⁷ ESOPs, originally intended to be a tool of corporate finance, employee motivation, and a tool for restructuring companies in an acclamation period of retiring owners, have come to be a tool largely used for the provision of retirement benefits and security.¹⁸

ESOPs, in particular, have a unique dichotomy between portfolio diversification and employee incentive—a see-saw effect between a lack of diversification and increased employee motivation. This tug-of-war between the benefits and downside risks of ESOPs, especially in the wake of the Enron scandal, has given rise to increased skepticism about the protections provided by ERISA. The downfall of Enron and the obliteration of employee benefits caused by the poor company retirement structure have given rise to the debate over the safety of many retirement plans covered under ERISA, and more specifically, the ESOP.¹⁹

Risks are often counterbalanced by safety mechanisms, leading to the question of what safety mechanisms exist to cushion the fall of the riskiest form of employee security—the ESOP.²⁰ One significant issue

15. Some examples of others are defined benefit plans, defined contribution plans, 401(k)s, and hybrid plans.

16. See generally Employee Retirement Income Security Act (ERISA) of 1974 §§ 1-4402, 29 U.S.C. §§ 1001-1461 (2006).

17. See Ezra S. Field, *Money for Nothing and Leverage for Free: The Politics and History of the Leveraged ESOP Tax Subsidy*, 97 COLUM. L. REV. 740, 747-48 (1997). For example, ESOPs are “exempted from ERISA’s diversification rules . . . allow[ing] for investment [by the fiduciary] primarily in employer securities.” *Id.* ESOPs are also “exempted from almost every [form of] protection that ERISA can provide.” *Id.* at 747 (footnote omitted).

18. See The ESOP Association, *How Do ESOPs Work?*, http://www.esopassociation.org/about/about_use.asp (last visited Jan. 20, 2009) (claiming that about two-thirds of ESOPs now in place were started either as a way of corporate restructuring or as a way to provide employee benefits).

19. See, e.g., *Moench*, 62 F.3d at 568 (quoting *Martin v. Feilen*, 965 F.2d 660, 664 (8th Cir. 1992) (“[B]y its very nature ‘an ESOP places employee retirement assets at much greater risk than does the typical diversified ERISA plan.’”)).

20. Presently, there are few safety mechanisms in place since ESOPs are generally exempted from many of the security features provided for in ERISA and because there is currently no form of insurance available to protect the employee-investor. See discussion *infra* Parts III - IV on benefits,

that exists is that of insurance. While some plans under ERISA are guaranteed by insurance coverage by the federal government, namely the PBGC, ESOPs are neither privy to this governmental coverage, nor any private coverage.²¹ “[I]f 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.”²²

Through this Article, we will demonstrate how the creation of private insurance coverage for ESOPs would help to eliminate, or at least reduce, the problem of the large downside risks associated with these quasi-retirement plans. In order to fully develop this assertion and the reasoning behind it, we will explore how ESOPs fit within ERISA. We will also discuss the benefits and risks associated with ESOPs and the protections (and lack of protections) available to ESOPs under ERISA.

This Article is comprised of four sections. Part I is a brief introduction to ERISA, the PBGC, and ESOPs. This section discusses the creation of ERISA and the reasoning for its implementation. In this first section we also discuss the PBGC, its creation under ERISA, and the ways it helps to further one of the main goals behind ERISA—protecting employee benefit plans. This section will also give an introduction to ESOPs and their formation.

Part II will provide a more in-depth look at ERISA and the types of retirement plans that are covered under the statute. In this section, we discuss defined benefit plans, defined contribution plans, and hybrid plans. This section seeks to demonstrate the characteristics of each of the different retirement plans and the unique ways that these plans are treated under ERISA.

Part III explores ESOPs in greater detail. This section discusses the benefits to both employers and employees that result from the creation of an ESOP. Many ESOP experts claim that ESOPs help to increase wealth by promoting employee ownership and boost worker productivity and morale. In this section, we also discuss one of the primary benefits of the ESOP—the federal tax treatment of these plans. In order to promote the use of ESOPs, Congress has created several tax incentives and

risks, and insurance of ESOPs.

21. *Pension Benefit Guaranty Corporation: Hearing Before the S. Comm. on Finance*, 107th Cong. 1, 3 (2002) (statement of Steven A. Kandarian, Executive Director, PBGC), available at <http://finance.senate.gov/hearings/testimony/022702sktest.pdf>. “[ESOPs] are not defined benefit plans and so are not insured by PBGC.” *Id.* at 3. There are currently no private insurers who offer ESOP protection for employees. See discussion *infra* note 196 on insurance.

22. Kris Frieswick, *Split Personality: An ESOP is a Retirement Plan. No, It's an Ownership Investment. Wait – It's Neither One*, CFO, June 2003, at 73.

tax breaks, which are unique to these plans. The final issue addressed in this section deals with the risks that come about when an employer decides to form an ESOP. We discuss the ESOPs' exemption from many of ERISA's protections, such as the fiduciary's duty to diversify, as well as other risks such as a lack of investment diversity, an inability to control the rate of return, and the possibility that a fiduciary found liable may be insolvent.

Part IV is our proposal suggesting that insurance, which would protect against the ESOP's value falling below a certain level, is a reasonable, efficient, and effective way to reduce the risks associated with ESOPs, while still maintaining the benefits. We suggest that, in light of the current problems plaguing the PBGC, this insurance would be better provided by the private sector, rather than the PBGC or a similar government agency. We propose a mandatory insurance program to combat moral hazard and adverse selection problems. An insurance program would be advantageous, as it would limit the investment risk, increase awareness, and promote the growth of ESOPs as a vehicle for retirement planning. While there may be potential criticisms for ESOP insurance, these potential criticisms will not be a barrier to the success or effectiveness of this insurance.

I. BACKGROUND: ERISA, ESOPs, AND THE PBGC

A. *The Creation of the Employee Retirement Income Security Act of 1974*

Following the Great Depression, the government attempted to provide some assistance to retired American employees.²³ Though the Social Security Act of 1935²⁴ provided the mainstay of the American pension system—the Social Security system—unaddressed issues remained and pension worries continued.²⁵ The government enacted ERISA—a

23. Kathleen H. Czarney, *The Future of Americans' Pensions: Revamping Pension Plan Asset Allocation to Combat the Pension Benefit Guaranty Corporation's Deficit*, 51 CLEV. ST. L. REV. 153, 158 (2004). The Great Depression had created a situation of widespread unemployment and had adversely affected employee pensions. *Id.* In turn, Congress was motivated to provide some type of protection to American workers. *Id.*

24. Pub. L. No. 74-271, 49 Stat. 620 (codified as amended at 42 U.S.C. §§ 301-1397j (1935)).

25. Czarney, *supra* note 23, at 158-59. The United States' Social Security system is in the midst of a "solvency crisis," whereby many workers, especially of the "Baby Boom" generation, fear that there will be insufficient funds and inadequate resources to fund future payments to retirees

large-scale endeavor “to provide pension benefit security for employees and their beneficiaries”—in 1974.²⁶ ERISA was aimed at alleviating a number of deficiencies in the retirement system and filling in the gaps where benefit plans seemed to lack clarity.²⁷ ERISA addressed issues previously left open, such as disclosure requirements to plan participants, the funding regime, plan terminations and the consequences of fiduciary misbehavior.²⁸ ERISA laid out a plan of increased reporting and disclosure requirements and an elaborate system of standards to which employers must adhere.²⁹

Although ERISA covers a variety of employer plans, a number of groups were left without the benefits and protections of this coverage.³⁰ ERISA fails to cover pension plans under the Railroad Retirement Act, pension plans that deal with an international corporation, and plans that have a distinct purpose of complying with “unemployment compensation, workmen’s compensation, or disability insurance laws.”³¹ Another notable “exclusion” from most of ERISA is that of ESOPs, whose very nature makes them a prime candidate for protection.³² ESOPs fall under the category of defined contribution plans³³ and, while they are not totally unmentioned or excluded from the ERISA statute itself, they do not receive many of the protections afforded to defined benefit plans or many other types of defined contribution plans.³⁴ For example, “[a]lthough ERISA regulates participation, funding, vesting, accrual, fiduciary duty and disclosure requirements for both defined benefit and defined contribution plans, the PBGC guarantees only relate to defined benefit plans and fail to protect benefits of defined contribution plans.”³⁵ This Article proposes that ESOP insurance would be an effective way to

and beneficiaries. *Id.*

26. *Id.* at 159; see ERISA, §§ 1-4402, 29 U.S.C. §§ 1001-1461 (2006). ERISA originated in 1962 with the creation of a task force by President John F. Kennedy and was signed into law by President Gerald Ford in 1974. Czarney, *supra* note 23, at 159 (citing 120 CONG. REC. 29934, 31064 (1974) (statement of Sen. Javits)).

27. Czarney, *supra* note 23, at 159.

28. *Id.*

29. *Id.*

30. *Id.* at 160.

31. *Id.*

32. See, e.g., ERISA § 1107(b)(2)(B)(iii) (exempting ESOPs from this particular section of ERISA); see also Field, *supra* note 17, at 741 (“ERISA exempted ESOPs from substantially all of the protections it otherwise put in place to protect pension plan assets.”).

33. Defined contribution plans are explained and discussed *infra* in Part II of this Article.

34. See ERISA §§ 1-4402.

35. Sharon Reece, *Enron: The Final Straw & How to Build Pensions of Brick*, 41 DUQ. L. REV. 69, 80 (2002) (footnote omitted).

combat the risks created by ESOPs' exclusion of many of ERISA's protections.

B. The Pension Benefit Guaranty Corporation

The goal of Congress in enacting ERISA was "to improve and protect employee benefit plans, including pension plans."³⁶ One way of achieving this goal was the establishment of the PBGC.³⁷ The PBGC is a government-owned insurance corporation located within the Department of Labor,³⁸ which presently insures defined benefit plans for around forty-four million workers and retired individuals.³⁹ The PBGC insures only defined benefit plans, so ESOPs and other defined contribution plans do not fall within its protection.⁴⁰ One reason the PBGC does not cover defined contribution plans is that "[such] plans are always fully funded; therefore, there is no need for termination insurance protection."⁴¹ One of the main contentions of this Article, however, is that just because the plans are "always fully funded" does not mean that they are without risk and, therefore, could not benefit from insurance protection. The risk is not created by the funding of the plan, but rather by the success of the plan's investments, which are mostly in the company's own stock.

The three main goals of the PBGC are: (1) to encourage private pension plan growth; (2) to disburse "timely and uninterrupted" benefits when companies insured by the PBGC are unable to fulfill their pension obligations; and (3) to maintain the "lowest possible" premiums.⁴² The PBGC takes over a pension plan's assets only at the plan's termination, which occurs only upon:

- (1) death of the plan participant; (2) disability, retirement or severance of employment by the plan participant; (3) termination of the plan by the employer or the PBGC; or (4) attainment of normal retirement age as provided for in the plan. Additionally, the PBGC may terminate the plan involuntarily or the employer may terminate the plan voluntar-

36. Leigh Allyson Wolfe, *Is Your Pension Safe? A Call for Reform of the Pension Benefit Guaranty Corporation and Protection of Pension Benefits*, 24 SW. U. L. REV. 145, 147 (1994).

37. *Id.* at 148.

38. *Id.*

39. Czarney, *supra* note 23, at 179.

40. *See* Wolfe, *supra* note 36, at 149.

41. *Id.* at 150.

42. *Id.* at 148.

ily.⁴³

An illustration of how the PBGC works is that once an employer lacking adequate assets to cover its pension obligations terminates its pension plan, the PBGC steps in as trustee.⁴⁴ The PBGC assumes “the plan’s assets and liabilities . . . [and] disburses the plan’s assets to cover what it can of the benefit obligations.”⁴⁵ Once those assets are distributed, the PBGC uses its own funds to continue payment of the employees’ pension benefits to the employees.⁴⁶ ERISA restricts the amount of benefits guaranteed by the PBGC.⁴⁷ Currently, the cap is around \$4,000 per month for an employee who retired when he or she was sixty-five years old.⁴⁸ That amount is reduced if the employee begins receiving benefits prior to reaching sixty-five years of age, “or if [the] pension includes benefits for a survivor or other beneficiary.”⁴⁹ Although the PBGC’s coverage “does not guarantee” that employees will receive the entire pension promised to them by the employer, “it does provide some compensation to the employee.”⁵⁰ Reimbursement from the employer can be sought by PBGC by filing a claim after providing the employees with their benefit payments.⁵¹

The PBGC, as contrasted with other government organizations, is not financed through tax dollars.⁵² Instead, the PBGC is subsidized through three main sources: (1) “annual insurance premiums paid by the administrators of covered plans” (the companies who sponsor the plans);⁵³ (2) “recoveries from employers’ terminated underfunded plans”; and (3) “investment returns on its assets.”⁵⁴ The PBGC’s premium structure is two-tiered⁵⁵ and the rates are set by Congress.⁵⁶ To begin with, there is a flat-rate annual charge of \$19 for every worker

43. Czarney, *supra* note 23, at 175.

44. *Id.*

45. *Id.*

46. *Id.* at 176.

47. *Id.* at 176, 178.

48. *Id.* at 178.

49. *Id.*

50. *Id.* at 177.

51. *Id.* at 175.

52. *Id.* at 177.

53. *Id.*

54. Wolfe, *supra* note 36, at 148.

55. *Id.* at 154.

56. Amy Borrus, *Pensions on a Precipice*, BUS. WK. ONLINE, Aug. 26, 2004, http://www.businessweek.com/print/bwdaily/dnflash/aug2004/nf20040826_2426_db035.htm?chan=db.

whose pension is insured.⁵⁷ In addition, there is a fee for unfunded benefits of \$9 per every \$1,000 of promised benefits.⁵⁸

C. Introduction to ESOPs

ESOPs, typically utilized as either a means of restructuring a closely held company in the wake of an owner's retirement or as an additional benefit or incentive plan for employees⁵⁹ are created as follows⁶⁰: The trust that is generated in accordance with the ESOP borrows whatever amount of money is needed by the employer at the time and the employer assures that the loan will be paid back.⁶¹ The trustee subsequently goes to the employer and utilizes the borrowed money to purchase shares of stock.⁶² "The employer has no taxable income on [this] sale of its [shares] to the ESOP";⁶³ however, it receives funds which it can use to finance projects. "These shares [of stock] are pledged as collateral for the loan and are held in a suspense account by the trustee"⁶⁴ The employer draws on the proceeds produced from this new asset to make yearly deposits to the trust; such contributions being at a minimum equal to the amount the trust must repay on the loan.⁶⁵ As the ESOP uses these contributions to pay off the loan, the trustee discharges shares of stock, which are distributed to the plan participants—the employees.⁶⁶ Generally, the stock is kept in the employee's ESOP account and is disbursed to the employee at the conclusion of his or her employment.⁶⁷

ESOPs were created by Louis Kelso under the theory that the capitalist system would be strengthened if workers had ownership.⁶⁸ Use of

57. Wolfe, *supra* note 36, at 154.

58. *Id.*

59. See ESOP Association, *supra* note 18 (discussing that it is likely that two-thirds of existing ESOPs were created for one of these reasons). Additional uses include: making a business private, funding an acquisition or expansion, etc. *Id.*

60. A clear chart illustrating how the basic ESOP works can be found at LOUIS O. KELSO & PATRICIA HETTER KELSO, *DEMOCRACY AND ECONOMIC POWER: EXTENDING THE ESOP REVOLUTION* 60 fig.7-1 (Ballinger Publ'g Co. 1986).

61. Michael W. Melton, *Demythologizing ESOPs*, 45 TAX L. REV. 363, 366 (1990). The money can be used, for example, to purchase new equipment. *Id.*

62. *Id.*

63. *Id.* at 367.

64. *Id.* at 366-67.

65. *Id.* at 367.

66. *Id.* The most common way of allocating the shares of stock is in proportion to the employee's wages. *Id.*

67. *Id.*

68. NCEO, *AN INTRODUCTION TO ESOPS* (9th ed. 2008), as reprinted in *A Short History of*

ESOPs rose dramatically after the passage of ERISA—“which governs employee benefit plans and established a statutory framework for ESOPs”—was passed.⁶⁹ ESOPs are now very important to millions of Americans.⁷⁰ Currently, there are around 11,000 ESOPs and comparable stock bonus plans which involve more than 8.5 million employees.⁷¹ ESOPs can be found in many different sized companies; however, due to the high start up and administration costs of ESOPs, most companies that utilize them have at least fifteen employees.⁷²

At the time ERISA was passed, ESOPs were not central to the Act,⁷³ and while ERISA put in place safeguards protecting other types of pension plans, ESOPs were exempted from almost all of these safety measures.⁷⁴ For example, ERISA generally requires plan fiduciaries to diversify investments in order to minimize risk;⁷⁵ however, ESOPs are exempt from this diversification requirement, so the fiduciary is “allow[ed] [to] invest[] primarily in employer securities.”⁷⁶ There was purportedly no cost-benefit analysis performed before ESOPs were incorporated into ERISA,⁷⁷ which is significant because it shows that in writing ERISA, consideration was most likely not given to the risks of ESOPs and whether they should be guaranteed, insured, or left to the decisions made by individual employees and plan fiduciaries.

II. COVERAGE OF ERISA

The original, expressed objective of ERISA was to regulate and provide protection for “employee pension benefit plans,” and all the plans that fell beneath this very broad umbrella.⁷⁸ Typically, employee

the ESOP, NCEO, 2000, <http://nceo.org/library/history.html>.

69. *Id.*

70. See Press Release, The ESOP Ass’n, Presidential Candidates Miss Golden Opportunity in Ownership Debate (Sept. 3, 2004), *available at* http://www.esopassociation.org/media/media_pressreleases_090304.asp.

71. NCEO, *supra* note 68.

72. *Id.*

73. Field, *supra* note 17, at 748.

74. *Id.* at 741.

75. See discussion on risk and diversification *infra* notes 209-28.

76. *Id.* at 747-48.

77. *Id.*

78. See ERISA § 2, 29 U.S.C. § 1001b(c) (2006); Reece, *supra* note 35, at 76. The ERISA statute defines “employee pension benefit plans” as:

[A]ny plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program—(i) provides retirement income to employees, or (ii) results in a deferral of in-

benefit plans fall within two distinct categories—defined benefit plans and defined contribution plans.⁷⁹ There are other types of plans that combine aspects of these two plans, incorporating different elements to create plans better suited to companies' needs, and hence warranting different protections.⁸⁰ A basic understanding of the different types of benefit plans will lead to a more in-depth understanding of how ESOPs are the “black sheep” of retirement plans.

A. Defined Benefit Plans

ERISA classifies a “defined benefit plan” as “a pension plan . . . which is not an individual account plan and which provides a benefit derived from employer contributions which is based partly on the balance of the separate account of a participant.”⁸¹ More simply put, a defined benefit plan is a retirement plan established in such a way as to pay a fixed annual amount to qualified employees following their retirement, for a set number of years.⁸² The quarterly or annual contribution which each employee must make to the retirement plan is based upon an actuarial determination of what the employee's retirement benefits should be, not on profits that are expected to come from the plan.⁸³ The employer's periodic contribution to the plan is also based upon the amount of the benefit promised to the employee.⁸⁴ The precise payment that the

come by employees for periods extending to the termination of covered employment or beyond, regardless of the method of calculating contributions made to the plan, the method of calculating benefits under the plan or the method of distributing benefits from the plan.

ERISA § 3(2)(A).

79. Reece, *supra* note 35, at 76-77. Examples of defined contribution plans include: ESOPs, 401(k)s, Profit-Sharing Plans, 403(b) Annuities, Stock Bonus Plans, and Money Purchase Plans. *Id.* at 78.

80. *See id.* at 77. For example, a KSOP is similar to an ESOP in regards to its equity ownership provisions, but incorporates the “savings element[s] of a 410(k) plan.” Bob L. Sellers, ‘KSOP’—A Plan That Adds Shareholder Value. (*An Employee Stock Ownership Plan Using a 401-k*), 85 A.B.A. BANKING J. 27, 27 (1993).

81. ERISA § 3(35).

82. *See* U.S. Department of Labor, Retirement Plans, Benefits & Savings: Types of Retirement Plans, <http://www.dol.gov/dol/topic/retirement/typesofplans.htm> (last visited Jan. 20, 2009).

83. Advanced Corporate Planning, Defined Benefit vs. Defined Contribution Retirement Plans, <http://401kpsp.com/401kdbdc.php> (last visited Apr. 8, 2009). However, the amount that each employee may contribute to the plan has a cap. *See* I.R.C. § 415(b)(1) (2006). The maximum amount that can be contributed to the plan each year is “the lesser of—(A) \$160,000, (B) 100 percent of the [employee's] average compensation” from his or her three peak successive calendar years. *Id.*; *see also* InvestorGuide University, Retirement Planning: Types of Retirement Plans, <http://www.investorguide.com/printarticle.cgi?ref=748> (discussing the contribution cap).

84. Reece, *supra* note 35, at 77.

retiree receives each month is based upon a “service and salary formula.”⁸⁵

Defined benefit plans provide a retired employee with a set amount of benefits, which are related to his or her earnings and period of time working at the company, preceding retirement.⁸⁶ ERISA established a number of rules in regards to defined benefit plans, including a mandatory vesting schedule so that workers can keep pension rights that they have legitimately earned throughout their time at the company,⁸⁷ the specific funding requirements, which provide safety for employees should their company experience future financial difficulties,⁸⁸ and a set of fiduciary duties for a plan’s fiduciary to direct them in the management of the defined benefit plan’s assets.⁸⁹

B. Defined Contribution Plans

According to ERISA, a “defined contribution plan” is a “pension plan which provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant’s account, and any income . . . which may be allocated to such participant’s account.”⁹⁰ These plans “do not guarantee a fixed level of income [like the defined benefit plan,] but [rather] involve an annual contribution by an employer.”⁹¹ While the employer is responsible “for the payment of the plan’s benefits and therefore bears the risk of accumulating insufficient assets” in a defined benefit plan, things are markedly different in a defined contribution plan.⁹² In this type of plan, the employee shoulders all the risk.⁹³ The employer’s duty to the employee reaches its conclusion after it’s contribution to the employee’s account.⁹⁴

Depending on the type of matching agreement in place, the employee, employer, or both deposit pre-tax money to these employee accounts at a fixed rate, all elaborated upon in the details of the defined

85. *Id.*

86. Field, *supra* note 17, at 746-47.

87. *See* ERISA § 203, 29 U.S.C. § 1053 (2006).

88. *See id.* §§ 301-08.

89. *See id.* § 404(c), 408(e).

90. *Id.* § 3(34).

91. Field, *supra* note 17, at 747.

92. Regina T. Jefferson, *Rethinking the Risk of Defined Contribution Plans*, 4 FLA. TAX REV. 607, 610-11 (2000).

93. Field, *supra* note 17, at 747.

94. *Id.* After the employer makes a contribution to the account, the account is then subject to whatever the employee and the market do to it. *See id.*

contribution plan.⁹⁵ “[T]he account is [then] invested for the employee.”⁹⁶ When the employee reaches retirement age, he or she collects the value of the account that has accumulated over the years.⁹⁷ The amount that is in the account is not guaranteed, as the amount will vary with contributions and forfeitures to and from the account, as well as market fluctuations of plan investments.⁹⁸

While employee investors bear significantly more risk in defined contribution plans than in defined benefit plans, the former has a number of advantages that make it quite appealing and attractive to certain types of employees. Defined contribution plans are more portable than defined benefit plans, drawing in the younger employees who are more mobile and less permanent with their job selections.⁹⁹ These types of plan are also easier to administer and manage, from an employer perspective.¹⁰⁰ The pressure is taken off of the employer to accumulate sufficient plan assets for distribution, and the employer is relieved of the task of managing the plan’s assets.¹⁰¹ With a smaller cost, and more benefits than drawbacks on the employer side, defined contribution plans have become the standard type of retirement plan.¹⁰² Despite the fact that defined contribution plans might seem less monitored than defined benefit plans, defined contribution plans are still regulated by ERISA in terms of their plan “participation, funding, vesting, accrual, fiduciary dut[ies], and disclosure requirements,” just like their defined benefit

95. Reece, *supra* note 35, at 78 (citing I.R.C. § 403(b) (2006)).

96. *Id.* (citing I.R.C. § 403(b)).

97. *Id.*

98. *Id.* Defined contribution plan assets are not insured by the PBGC, leaving employees to assume the risk of bad investments. See ERISA § 4021(b)(1). They may seek redress under ERISA. See *id.* § 3(34), 4(a).

99. Reece, *supra* note 35, at 78. The accounts, though established by the employer, belong to the employee. See *id.* (citing I.R.C. § 403(b)). The employee can take these plans with them to their next employer. See *id.* These accounts are referred to as “individual account plan[s]” under ERISA. ERISA § 3(34). Some “defined contribution plans [also] have more liberal vesting schedules than defined benefit plans . . . [,] pre-separation distributions . . . [, and employee] control over the investment of their plan assets.” Jefferson, *supra* note 92, at 615 (footnotes omitted); see also I.R.C. § 411 (2006).

100. Reece, *supra* note 35, at 79. For employers who have defined benefit plans, the regulations impressed upon them by ERISA have been more burdensome on those employers as contrasted with those that support defined contribution plans. Jefferson, *supra* note 92, at 614. Sponsors of defined contribution plans have had to revise their plans less often than those sponsors of defined benefit plans, creating reason enough for the visible shift towards defined contribution plans. Jefferson, *supra* note 92, at 614-15.

101. Reece, *supra* note 35, at 79.

102. See Jefferson, *supra* note 92, at 614. Defined contribution plans are significantly cheaper than defined benefit plans because no charge imposed on the employer for actuarial services, and since they are not covered by the PBGC, there are also no PBGC insurance premiums. *Id.*

counterparts.¹⁰³ A shortfall of defined contribution plans is that many of the provisions of ERISA are not applicable to defined contribution plans, making them a riskier form of retirement investment, with some types of defined contribution plans even exempted from the sections regarding self-dealing and diversification of the retirement portfolio.¹⁰⁴

One of the most common defined contribution plans is the 401(k).¹⁰⁵ 401(k) plans are a relatively new breed of retirement benefit plan¹⁰⁶ and warrant some attention due to their prevalence in the workplace and recent media attention.¹⁰⁷ 401(k) plans, also known as qualified cash or deferred arrangements (“CODA”), were so designated after section 401(k) of the Internal Revenue Code, which sets forth the requirements that a plan must adhere to in order to be eligible for “special tax treatment.”¹⁰⁸ This type of defined contribution plan has the same benefits of portability as other defined contribution plans, but gives employees a higher degree of control, or semblance of control, over their future benefits.¹⁰⁹ In a 401(k) plan, part of the employee’s pre-tax earnings are put into the 401(k) plan.¹¹⁰ Oftentimes, this amount is matched by the employer.¹¹¹ While the plan limits the amount that can be put into it at any one time, there is no ceiling to how much money can accrue in the 401(k) plan over time.¹¹² Employees are also given the added benefit of being able to withdraw amounts from the 401(k) plan “as a loan or hardship withdrawal.”¹¹³

103. Cf. Reece, *supra* note 35, at 80.

104. Field, *supra* note 17, at 747.

105. See Reece, *supra* note 35, at 79.

106. See Susan J. Stabile, *Freedom to Choose Unwisely: Congress’ Misguided Decision to Leave 401(k) Plan Participants to Their Own Devices*, 11 CORNELL J.L. & PUB. POL’Y 361, 361 (2002) (stating that up until about twenty years ago, defined benefit plans were the primary method of providing income security to employees). 401(k) plans were not envisioned when ERISA was put in place and only became possible with the 1978 Amendments to the Internal Revenue Code. See Revenue Act of 1978, Pub. L. No. 95-600, § 135(a), 92 Stat. 2763, 2785-87 (1978) (codified as amended at I.R.C. 401(k)).

107. See Reece, *supra* note 35, at 82. 401(k) plans gained recent media attention with the losses that employees suffered with the demise of Enron. *Id.* 401(k) plans now comprise the majority of retirement plans and the majority of employees involved in a retirement benefits. Stabile, *supra* note 106, at 361 n.2.

108. Reece, *supra* note 35, at 82.

109. See *id.* at 83.

110. *Id.*; U.S. Department of Labor, *supra* note 82.

111. Reece, *supra* note 35, at 83; U.S. Department of Labor, *supra* note 82.

112. Reece, *supra* note 35, at 83.

113. *Id.*

C. Hybrid Plans

Hybrid plans are employee retirement plans that have characteristics of both defined benefit plans and defined contribution plans.¹¹⁴ One of the most popular types of hybrid plans are the cash balance and floor offset plan.¹¹⁵ Under the cash balance and floor offset plan, instead of having the assets put in with the general pool of assets (like in a defined benefit plan), employees have “accounts” which “are credited with a portion of their salary and interest every year.”¹¹⁶ In this way, the defined benefit is calculated with a method similar to the defined contribution method.¹¹⁷ The cash balance plan is still insured by the PBGC because it retains some aspects of a defined benefit plan—most notably, it does not rely on employee contributions.¹¹⁸

III. EMPLOYEE STOCK OWNERSHIP PLANS

ESOPs are a form of defined contribution plan.¹¹⁹ According to ERISA:

The term “employee stock ownership plan” means an individual account plan—

(A) which is a stock bonus plan which is qualified, or a stock bonus plan and money purchase plan both of which are qualified, under section 401 of Title 26, and which is designed to invest primarily in qualifying employer securities, and

(B) which meets such other requirements as the Secretary of the Treasury may prescribe by regulation.¹²⁰

ERISA’s definition is similar to the definition of ESOP found in section 4975(e)(7) of the Internal Revenue Code which also sets out

114. *See id.* at 80-81.

115. *Id.* at 80.

116. *Id.* at 81. The defined benefit plan “pools the plan’s assets in an aggregate trust fund,” later paying out a set amount to plan participants after their retirement, despite how the investments in the plan actually fare. Jefferson, *supra* note 92, at 610.

117. Reece, *supra* note 35, at 81.

118. *Id.*

119. *Id.* at 78.

120. ERISA § 407(d)(6), 29 U.S.C. § 1007(d)(6) (2006).

some further specific requirements to which ESOPs must conform, such as a requirement that generally an employee must be able to require his employer to distribute his benefits as employer securities or “if those securities are not readily tradable on an established market . . . to require that the employer repurchase [the] securities under a fair valuation formula”¹²¹ and requirements for distribution and payments of the employee’s account balance.¹²²

The employer who sponsors the ESOP makes contributions to a tax exempt trust, which is then “maintained for the benefit of [the] employees.”¹²³ “The trust . . . holds the contributions and earnings for the [ESOP] participants, and the participants defer recognition of the income until the benefits are received.”¹²⁴ Once the participants are eligible to receive the benefits that have accumulated in the ESOP, they are given the option to either collect stock or the equivalent value of the stock in a cash payment.¹²⁵

In order to create an ESOP, an employer must meet the following requirements: “(1) The plan document must absolutely state that the plan is an ESOP. (2) The ESOP cannot be integrated with Social Security. (3) The ESOP must generally have a definite formula for allocating contributions and forfeitures.”¹²⁶

ESOPs are privy to tax benefits that are not available with other types of retirement plans.¹²⁷ ESOPs are similar to other types of defined contribution plans in their ability to shift all risk to the employee.¹²⁸ However, ESOPs are riskier than other species of defined contribution plans because the “ESOP is a form of a pension plan that is exempted from almost every protection ERISA can provide.”¹²⁹ For example, ESOPs are exempt from the requirement of diversification and are allowed to engage in certain transactions that are typically impermissible under ERISA.¹³⁰ Therefore, ESOPs find themselves exempt from the

121. I.R.C. § 409(h)(1), 4975(e)(7) (2006).

122. *Id.* § 409(o), 4975(e)(7).

123. Melton, *supra* note 61, at 364.

124. *Id.*

125. *Id.* at 365.

126. Jeffrey H. Rattiner, *Share the Wealth*, FIN. PLAN., OCT. 2003, at 115.

127. See Field, *supra* note 17, at 747. A major benefit with ESOPs is that the employer can get a tax deduction on the principal and interest. Rattiner, *supra* note 126, at 116. Participants have the ability to “defer recognition of capital gains on distributions and special stock redemption provisions.” *Id.* Also, it is possible that tax will not need to be paid on “unrealized appreciation of stock” kept in the ESOP until distributions are made to the participants. *Id.*

128. Field, *supra* note 17, at 747.

129. *Id.*

130. *Id.* at 748, 748 n.53 (citing ERISA §§ 406, 408(e), 29 U.S.C. §§ 1106, 1108(e) (2006)).

diversification rules set forth in ERISA, leaving ESOPs open to invest in employer securities, and able to take part in transactions with “part[ies] in interest.”¹³¹

ESOPs can serve a variety of different purposes. Their intended use was to be a tool of corporate finance,¹³² rather than a retirement plan, but this has changed as of late.¹³³ Employers use ESOPs as a way of garnering extra tax benefits or even as a way to prevent hostile takeovers.¹³⁴ The prime reason given for the use of ESOPs is the extra boost given to worker productivity.¹³⁵ The boost in worker productivity comes from giving employees ownership in the company, which “[e]ncourag[es] these employees to take more pride in their work,” which in turn leads to a pro-employer atmosphere and increased productivity.¹³⁶

“ESOPs . . . are benefit plans” that employers establish for their employee participants “by funding employee trusts that invest in company stock.”¹³⁷ However, the very fact that the company is investing primarily in company stock makes it riskier than the norm,¹³⁸ especially given the fact that ESOPs are not insured by the PBGC.¹³⁹ ESOPs are not covered by the PBGC because they are defined contribution plans,

131. *Id.* at 748. For the most part, ERISA does not allow dealings where a conflict of interest is present; however, ESOPs are free from the constraints of this provision. *Id.* at 748 n.53 (citing ERISA §§ 406, 408(e)). It is the view of countless experts that the time has come to address this conflict of interest in ERISA and whether ESOPs should be included in ERISA. Frieswick, *supra* note 22, at 75. Former President Ronald Reagan’s effort to eliminate ESOPs from ERISA in 1985 was thwarted by Congress, but more recently, Rep. Cass Ballenger (R-N.C.) proposed a Presidential Commission to review the existing conflicts. *Id.*

132. There is, however, a good deal of authority claiming that all along Congress has intended ESOPs to be mainly a vehicle to promote employee ownership, as well as retirements savings plans. *See, e.g.,* Martin v. Feilen, 965 F.2d 660 (8th Cir. 1992) (quoting 129 CONG. REC. S16629, S16636 (Daily ed. Nov. 7, 1983 (statement of Sen. Long))). As J. Michael Keeling, President of The ESOP Association, stated in a letter to the authors of this Article, “[t]he legislative history of ESOPs since the mid-70’s is replete with statements that Congress intends ESOPs to be ownership plans.” Letter from Michael Keeling, President of The ESOP Ass’n, to authors (on file with authors). Under either view, ESOPs are now commonly used, among other things, as a way employees plan for retirement.

133. *See* Field, *supra* note 17, at 741-42.

134. Rattiner, *supra* note 126, at 115-16. ESOP’s can safeguard “against a hostile takeover, because [the company] stock is held by friendly employees,” not by outsiders. *Id.* at 115.

135. *See id.*

136. *Id.*

137. Corey Rosen, *Employee Ownership: A Good Benefit Plan, an Inadequate Retirement Plan*, NCEO, Dec. 2001, http://www.nceo.org/library/eo_retirement.html.

138. *See* discussion on risks associated with ESOPs *infra* Part III.D.

139. Czarney, *supra* note 23, at 169. *See generally* Pension Benefit Guaranty Corporation (PBGC), <http://www.pbgc.gov> (last visited Jan. 17, 2009) (discussing the PBGC).

and hence pay out based on a set amount.¹⁴⁰ The PBGC covers only defined benefit plans.¹⁴¹

A. Benefits of ESOPs—Incentives

1. Benefits to Employers

ESOPs can be very beneficial to small and mid-sized corporations because the ESOP allows the corporation to sell its stock for “top dollar,”¹⁴² while receiving tax benefits, without having to give up control of the company.¹⁴³ When the owner sells stock to the ESOP, the sale provides him with funds, which can be used to make improvements or investments, but still allows him to keep control of the company.¹⁴⁴ In addition to the financial benefits derived from the sale of employer stock to the ESOP, companies often perform better than would otherwise be expected when they provide for employee ownership,¹⁴⁵ especially when that “ownership is combined with a ‘high involvement’ management style.”¹⁴⁶ According to one study, the impact that the employee ownership has on a company’s financial success is not dependent on “[o]ther factors, such as the size of the company, unionization, line of business . . . age of the plan, [employees’] voting rights, etc. . . .”¹⁴⁷ In order for

140. See *supra* note 40-41 and accompanying text.

141. See *supra* note 40 and accompanying text. See generally Pension Benefit Guaranty Corporation (PBGC), *supra* note 139 (discussing what the PBGC insures).

142. David O’Leary, *Employee Stock Ownership Plans: An Innovative Succession Planning Strategy for Business Owners*, PRIVATE WEALTH SERVICES, (Holland & Knight LLP, Chicago, Ill.), June 18, 2004, available at <http://www.hklaw.com/id24660/PublicationId2162/ReturnId31/contentid49276/>. The term “top dollar” is used because the ESOPs often purchase the stock for more than a third-party would pay. *Id.*

143. *Id.* But see Field, *supra* note 17, at 743 (“ESOP transactions present complicated issues of valuation . . . [because (1)] the ESOP is often only assuming debt, not contributing cash to the transaction . . . [and (2)] the ESOP is essentially a captive party in the transaction, with no effective ability to negotiate fair terms.”).

144. See O’Leary, *supra* note 142.

145. See The ESOP Association, *supra* note 18. A study conducted in 1993 by the ESOP Association ascertained that 54% of member companies claim their ESOP is responsible for an overall rise in productivity. *Id.*

146. Corey Rosen, *A Guide to Doing Academic Research on Employee Ownership*, NCEO, May 2007, <http://www.nceo.org/library/research.html>.

147. *Id.* (discussing a 1983-1986 NCEO study that can be found in COREY M. ROSEN, KATHERINE J. KLEIN, & KAREN M. YOUNG, *EMPLOYEE OWNERSHIP IN AMERICA: THE EQUITY SOLUTION* (Lexington Books, 1985)).

the combination of employee ownership and employee participation to have a positive economic effect, however, the ownership needs to be “significant.”¹⁴⁸ Although there is no explicit cutoff to determine “‘significance,’ . . . it seems clear that contributions under 3%-4% per year are not going to get the employee’s attention unless the stock value is increasing in spectacular fashion.”¹⁴⁹ Along with this increase in economic performance, companies that provide for employee ownership often see their stock prices rise as a result.¹⁵⁰

2. Benefits to Employees

ESOPs also provide many benefits for employees. According to the National Center for Employee Ownership (“NCEO”), it is a common misconception that in order to have ownership in a company, employees must give up something else.¹⁵¹ In fact, the NCEO cites studies in which it was found that “employees are often significantly better compensated in ESOP companies than . . . employees in comparable non-ESOP companies.”¹⁵² According to Corey Rosen, under 1% of all ESOPs require employees to make concessions in their wages.¹⁵³ It has also been demonstrated that when employees are given a stake in the success of their company, their feelings about their company becomes more favorable.¹⁵⁴ This boost in employee moral, in turn, contributes to increased productivity and improvements in the bottom line.¹⁵⁵

148. *Id.*

149. *Id.*

150. *See id.* (citing various studies performed to see the influence on stock price).

151. *Id.*

152. Employee Ownership and Corporate Performance, <http://www.nceo.org/library/corpperf.html> (last visited Apr. 6, 2009) (citing a study conducted in 1998 by Peter Kardas and Jim Keogh of the Washington Department of Community, Trade and Economic Development and Adria Scharf of the University of Washington entitled *Wealth and Income Consequences of Employee Ownership*).

153. Corey Rosen, *ESOPs in Mergers and Acquisitions: Wave of the Future?*, NCEO, Apr. 2007, <http://www.nceo.org/library/esop-ma.html>.

154. ESOP Association, *supra* note 18. In addition to employees attitudes toward their companies improving, employees who own stock are often more satisfied with their personal financial status. *See* Press Release, The ESOP Ass’n, Survey Confirms Employee Ownership is Wide Spread in America (June 17, 2004), *available at* http://www.esopassociation.org/media/media_pressreleases_061704.asp. “[O]ver 80% of individuals who own company stock are more or less satisfied with their financial situation and another 78.9% of individuals strongly agree or agree that they have a good chance of improving their standard of living.” *Id.*

155. ESOP Association, *supra* note 18 (citing a 1993 study by the ESOP Association).

B. Tax Incentives for ESOPs

Congress provides benefits and incentives for ESOPs in the form of tax breaks. There are three main tax incentives granted by Congress which are meant to “promote increased use of the ESOP concept.”¹⁵⁶ Those three incentives are: deductions for employer contributions to the ESOP, “ESOP rollover” and deductions for dividends paid on the ESOP stock.¹⁵⁷ The first incentive is an incentive which is available to all qualified employee benefit plans, the second and third incentives are unique to ESOPs. First, “[a]s with all tax-qualified employee benefit plans,” employers who make contributions to ESOPs may then deduct those contributions from their income taxes, up to certain limits.¹⁵⁸ In the case of a leveraged ESOP (where the company takes out a loan to finance the purchase of employer stock), the employer can deduct contributions to the ESOP used to repay both principle and interest on the loan.¹⁵⁹ “This makes the ESOP an attractive form of debt financing for the employer from a cash flow perspective.”¹⁶⁰ Each year, a company may deduct contributions “up to 25% of covered payroll, plus any dividends on ESOP stock . . . which are used to repay the loan.”¹⁶¹ Additionally, there is no limit on contributed amounts used to repay interest on the loan—they are all deductible.¹⁶²

In addition to deductions for contributions to ESOPs, Congress has granted two additional tax incentives which are unique to ESOPs: “ESOP rollover” and “deductibility of dividends.”¹⁶³ “ESOP rollover” allows an employee shareholder in a closely-held company to sell his shares to the company’s ESOP and defer payment of federal income taxes on the gains from the sale.¹⁶⁴

In order to qualify for this “rollover,” the ESOP must own at least 30% of the company’s stock immediately after the sale, and the seller(s) must reinvest the proceeds from the sale in the securities of domestic

156. See generally ESOP Association, *Tax Advantages for Business Planning* (2004) at http://www.esopassociation.org/about/about_tax.asp (last visited Feb. 20, 2009) [hereinafter ESOP Tax].

157. *Id.*

158. *Id.*

159. *Id.*

160. *Id.*

161. *Id.*

162. *Id.*

163. *Id.*

164. *Id.*

operating corporations within fifteen months, either three months before, or twelve months after the sale.¹⁶⁵

ESOP rollover is especially beneficial to current or retiring owners, who would generally only be allowed to either sell their shares back to the company or to sell out to another company, either for cash or for shares in the other firm.¹⁶⁶ A seller of an ESOP, however, may limit the risk of his investments by exchanging his interest in the firm for a more diversified portfolio while avoiding taxes on the transaction.¹⁶⁷ Following such a sale, the seller's tax basis in the shares sold to the ESOP is carried over to the replacement stock.¹⁶⁸ If the replacement stock is held until the seller's death, it receives a stepped-up basis.¹⁶⁹ "ESOP rollover" is only available for an ESOP in a closely held domestic corporation where the seller has owned the stock for at least three years.¹⁷⁰

The third tax incentive is the deductibility of dividends paid on the ESOP stock.¹⁷¹ Employers are allowed to take a tax deduction for dividends paid on stock which was purchased as part of the ESOP to the extent that the employees are the ones receiving the dividends.¹⁷² While the dividends are still taxable as regular income to the employees, this provision gives a tax deduction to an employer who wishes to "share current benefits of stock ownership with their employees to complement the long term benefits of capital ownership."¹⁷³

C. Statistics on the Benefits of ESOPs

Despite all the risks associated with ESOPs,¹⁷⁴ companies are continuing to promote employee ownership through employee stock ownership plans. Today, millions of Americans own company stock, many of them because of an ESOP created by their employer.¹⁷⁵ It is clear from this growth of the popularity of ESOPs that employee ownership offers many benefits that traditional forms of compensation do not. Three examples of these benefits to companies are that: (1) ESOP companies of-

165. *Id.*

166. *Id.*

167. *Id.*

168. *Id.*

169. *Id.*

170. *Id.*

171. *Id.*

172. *Id.*

173. *Id.*

174. The risk referenced is in regard to both companies and employees.

175. NCEO, *supra* note 68.

ten perform much better than similarly situated non-ESOP companies.¹⁷⁶ (2) Companies with ESOPs in place “file for bankruptcy less often than companies that do not have ESOPs.”¹⁷⁷ (3) Companies that have ESOPs in place “are purchased by outsiders less often than their non-ESOP counterparts.”¹⁷⁸

Numerous studies have also indicated that ESOPs are beneficial for both the sponsoring corporation and its employees. The Employee Ownership Foundation’s 13th Annual ESOP Economic Survey found that 88% of companies said that creating an ESOP was “a good decision that has helped the company.”¹⁷⁹ Another recent study found that “[i]n total shareholder return, companies with ESOPs outperformed those without by almost [seven] percent.”¹⁸⁰ This study examined the financial performance of more than 380 U.S. public companies two years before and four years after adopting ESOPs.¹⁸¹ Additionally, a 1998 study from the state of Washington found that employees in ESOP companies have retirement assets that are approximately 150% greater than non-ESOP participants.¹⁸² This means that the average employee who retires from a company with an ESOP in place will have approximately two and a half times as much to spend during his or her retirement than the average employee from non-ESOP company.¹⁸³

D. Risks of ESOPs

ESOPs are an inherently risky form of employee retirement device. While there are many positive and beneficial attributes of these stock plans, there are also a number of risks associated with the administration and structure of ESOPs.

176. See Christopher Mackin & Loren Rodgers, “*But What About United Airlines?*” *Answering Tough Questions*, THE ESOP REPORT, Jan. 2003, at 3, available at http://www.ownershipassociates.com/united_questions.shtml (“employees in ESOP companies have retirement assets that are approximately 150% greater than non-ESOP participants”).

177. *Id.*

178. *Id.*

179. Press Release, ESOP Association, Employee Ownership Proves to be “Good” Business Decision (Aug. 19, 2004).

180. *ESOP Performance at a Glance*, MGMT. REV., Oct. 1999.

181. *Id.*

182. See Mackin & Rodgers, *supra* note 176, at 3.

183. *Id.*

1. Financial Risks to the Company

Along with providing the benefits described above, ESOPs, like any other investment in stock, are also inherently risky for both the company and the employee.¹⁸⁴ Although the goal of ERISA is to “assure the equitable character of [employee benefit plans] and their financial soundness,” there is no known way to guarantee that investments, even in strong companies, will not fail.¹⁸⁵ For example, during the Enron scandals, as new improprieties and questions came to light on a daily basis, once strong companies quickly found their prospects for continued success seriously questioned.¹⁸⁶

Risk for the company is also created by the fact that the company takes on significantly more debt when it implements an ESOP, and the debt absorbs much of the company’s cash flow.¹⁸⁷ By tying up a significant portion of the company’s cash flow, the ESOP hinders the ability of the company to remedy any financial situations that might require the use of more liquid forms of assets.¹⁸⁸ Significant cash obligations on the part of the company also arise when the company has the responsibility of repurchasing the shares of participants at retirement.¹⁸⁹ “Distribution of vested balances in the ESOP must begin [to be distributed] not later than one year after the close of the plan year in which the participant retires, becomes disabled, or dies.”¹⁹⁰ In other situations, such as where the employee leaves the job for other reasons, the distribution of vested balances must not begin later than five years after the ESOP participant ends his or her employment with the company.¹⁹¹ While the payment does not have to be made in a single distribution, and may instead be spread out over five years, payments still must be made every year.¹⁹²

184. See *Moench v. Robertson*, 62 F.3d 553, 568 (3d Cir. 1995) (“[A]n ESOP places employee retirement assets at much greater risk than does the typical diversified ERISA plan.”).

185. *Id.* at 560.

186. See H. Douglas Hinson & Patrick C. DiCarlo, *Fiduciary Duties and Investments in Employer Securities*, 29 J. PENSION PLAN. & COMPLIANCE 20, 20 (2003).

187. Field, *supra* note 17, at 742.

188. Leveraged ESOPs use borrowed funds to purchase company stock. O’Leary, *supra* note 142, at 1. The stock purchased with the loan proceeds serves as collateral. *Id.* In non-leveraged ESOPs, the ESOP purchases a company’s stock by using existing plan assets, assets or other qualified plans of the company, or annual company contributions. *Id.*

189. Stanley B. Block, *The Advantages and Disadvantages of ESOP’s: A Long Range Analysis*, 29 J. SMALL BUS. MGMT. 15, 17-18 (1991).

190. *Id.* at 18. This type of distribution requirement is true unless the participant elects otherwise. *Id.*

191. *Id.*

192. *Id.*

Obviously, this can pose a significant strain on the cash flow of the company sponsoring the ESOP.¹⁹³

The cash obligations imposed upon the company can be rather large, and companies should therefore have a plan established at the outset of the ESOP about how they will handle such matters, as problems might exist for companies that do not develop a systematic plan for meeting their obligations.¹⁹⁴ If companies failed to consider all necessary factors, such as the size of the workforce, the potential or probable length of employment, the methods of vesting, formulas for allocating shares, or other criteria, it is possible that plan sponsors might find that they have miscalculated their needs in terms of their necessary cash flow.¹⁹⁵

2. Risks to Employees

a. Insufficient Knowledge

Currently, no method of insurance exists to protect the ESOP plan participants if the investments do fail, creating a considerable amount of risk for all those involved in the ESOP—in terms of both benefits and administration.¹⁹⁶ Because of this, there is no safety net to catch employees when their retirement savings dwindle. The typical response to this risk is that ESOPs are investments and that the employees should realize that the value of the investment is dependent on the financial performance of the employer.¹⁹⁷ The problem is that often neither side completely realizes the risks they are facing or has the necessary knowledge to assess the risk.¹⁹⁸

193. *See id.*

194. *Id.*

195. *Id.*

196. One company currently offers fiduciary insurance, which protects the fiduciary or plan's sponsor in case of a lawsuit, but this does nothing to protect the employees from the prices of the employer's stock falling. *See* ESOP Association, *Resource Library – Insurance Programs: ESOPs and Fiduciary Liability Insurance*, http://www.esopassociation.org/resources/resources_fiduciary.asp (last visited Mar. 8, 2009) [hereinafter *ESOP Fiduciary Insurance*]. ESOPs are not covered by the PBGC or any other governmental insurance. Field, *supra* note 17, at 742. Additionally, in a letter to the authors of this Article, David R. Johanson, a partner at Johanson Berenson LLP, confirmed that “[t]here are [currently] no private insurers who cover the investment risk associated with holding company stock.” (on file with authors).

197. *See* *Moench v. Robertson*, 62 F.3d 553, 570 (3d Cir. 1995).

198. For example, one of the most common complaints that critics make about the private pen-

Employees are often unaware of the difference between defined benefit plans and defined contribution plans, especially with regards to the requirements and burdens on plan sponsors.¹⁹⁹ In certain respects, the risk for the employees is created by not knowing that the ESOP plan will not guarantee a specific rate of return.²⁰⁰ Because the ESOP is built around the employer's stock, there is currently no way of ensuring a minimum level of return, or even guaranteeing that the stock will be worth anything by the time the employee is ready to retire.²⁰¹ “[C]ritics have pointed out that ESOPs are inherently risky for employees because, instead of diversifying their assets, ESOPs invest their retirement income back into the company for which they already work, and because, unlike many ERISA plans, ESOPs are not insured by the [PBGC].”²⁰² This type of situation is risky because if the company fails the employee not only loses his job, but also the way to finance his retirement.²⁰³ In the end, the main source of risk arises not from the fact that a specific rate of return cannot be guaranteed, as this is a concept imbedded in all defined contribution plans, but rather the notion that the ratio of risk to expected return cannot be guaranteed.²⁰⁴

b. Fiduciary Responsibilities

The actions of the ESOP plan's fiduciaries and their ability to skirt and avoid liability in certain instances may impose a burdensome risk on plan participants. Under the ERISA statute, a fiduciary is appointed to manage the ESOP.²⁰⁵ All assets of an ESOP, usually the stock of an employee or sponsor, are held in trust.²⁰⁶ It is the responsibility of the

sion system as it currently exists is that employees often do not understand the options they have or the choices they are expected to make. Reece, *supra* note 35, n.72.

199. *See id.* at 81 and n.72 (illustrating the “devastating[ly]” complicated nature of the Department of Labor's explanation of the two distinct plans, which is aimed at providing employees with some level of clarification).

200. This type of uncertainty and risk is the focus of this Article.

201. Amy J. Maggs, *Enron, ESOPs, and Fiduciary Duty*, 16 BENEFITS LAW J. 42, 50 (2003) (“With so much of their future tied to their place of employment, to also have an employee's ‘happy ever after’ retirement income tied to the success of their employer compounds the risk and loss faced if the company were to fail.”).

202. Field, *supra* note 17, at 742.

203. *See generally* Maggs, *supra* note 201, at 50 (noting that of the various risks associated with ESOPs, “most of them fall on the employee”).

204. *See id.* at 51 (discussing level of employee risk in a defined contribution plan).

205. *ESOP Fiduciary Insurance*, *supra* note 196.

206. *Id.*

fiduciary or trustee to manage these assets of the trust.²⁰⁷ The ESOP fiduciary exercises discretion in two main areas: the purchase and sale of employer stock and voting on employer stock.²⁰⁸

In general, under ERISA, fiduciaries must act solely in the best interests of the plan participants.²⁰⁹ They must exercise skill, care, prudence, and diligence in the manner in which they manage the employee benefit plan.²¹⁰ A fiduciary that is found to be in breach of these duties and responsibilities, set forth in the statute, is liable to the plan for resulting losses and must repay any gains made by misuse of the plan assets.²¹¹ Co-fiduciaries may be responsible for breaches by other fiduciaries if they conceal the wrong-doing or do nothing to correct the problem once they know of it.²¹²

The Department of Labor does not have the resources necessary to adequately ensure that ERISA's fiduciary guidelines are being implemented properly, hence making the standards for plan fiduciaries more lax than they otherwise should be.²¹³ One such example would be ERISA's exemption of plan fiduciaries from the ordinary diversification requirement with respect to investments in employers' securities.²¹⁴ Because ERISA's "per se prohibitions" against certain kinds of transactions do not apply to purchases or sales by an individual account plan of qualifying employer securities, plan fiduciaries are somewhat less regulated than perhaps would be desired.²¹⁵ In general, plan fiduciaries are exempt from ERISA's otherwise stringent ban on self-dealing and conflicts of interest in dealing with investments in employer stock.²¹⁶ Individual account plans are further shielded due to their exemption from the ten percent cap on a plan's holdings of employer securities.²¹⁷

207. *Id.*

208. *See id.* (discussing major ESOP fiduciaries main areas of responsibility).

209. Professional Insurance Associates, *Fiduciary Liability Insurance*, at <http://www.piainc.com/fiduciaryliabilityinsurance.htm> (last visited Mar. 28, 2005).

210. *Id.*

211. *Id.*

212. *Id.*

213. Field, *supra* note 17, at 743.

214. Hinson & DiCarlo, *supra* note 186, at 21. *See* Employee Retirement Income Security Act (ERISA) of 1974 § 404(a)(2), 29 U.S.C. § 1104(a)(2) (2005).

215. *See* Hinson & DiCarlo, *supra* note 186, at 21. It is feasible to assume that participants in a plan that invested in the securities of an employer would like a greater level of protection afforded by more limitations and prohibitions placed upon the fiduciary entrusted with the management of their future income and benefits.

216. *Id.*; *see also* ERISA § 404(a)(2); *Brown v. Am. Life Holdings, Inc.*, 190 F.3d 856, 860 (8th Cir. 1999).

217. ERISA § 407(b)(1).

Congress specifically encourages employee stock ownership through the use of ESOPs, despite the fact that these plans are individual account plans that invest solely in qualifying employer securities.²¹⁸ Through the Tax Reform Act of 1976,²¹⁹ Congress overtly expressed its view that courts should not interfere with the goal of encouraging employee stock ownership through ERISA retirement plans by way of constructing barriers.²²⁰ By Congress standing in the way to tougher regulation, it is more difficult to shield employees from the actions of their plan fiduciaries.

Although Congress intended to provide an incentive for employee stock ownership, they did not *completely* exempt investments in employer stock from all requirements under ERISA.²²¹ Investments in stock of the employer are not exempted from ERISA's prudence and loyalty requirements.²²² The prudence requirement creates an obligation for fiduciaries to act with 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 with like aims.²²³ This concept of the prudent man is at odds with the policy of promoting employee stock ownership.²²⁴ On one hand, Congress intends to encourage the formation of ESOPs by way of favorable treatment and expressed desire for a backing-off of judicial and administrative authorities.²²⁵ On the other hand, ERISA is in place to provide protection for participants in employee benefit plans by enforcing high standards of fiduciary responsibility.²²⁶ To address these

218. Hinson & DiCarlo, *supra* note 186, at 21-22. Encouragement is mainly in the form of tax incentives, such as income tax deferrals for plan sponsors, tax deferrals to sellers of stock to ESOPs, and favorable tax treatment to particular types of additions to participant accounts (delineated in the statute). See I.R.C. § 404(a)(9), 404(k) (West 2007).

219. Pub. L. No. 94-455 § 803(h), 90 Stat. 1590 (1976).

220. Hinson & DiCarlo, *supra* note 186, at 22.

The Congress is deeply concerned that the objectives sought by [the laws encouraging ESOPs] will be made unattainable by regulations and rulings which treat employee stock ownership plans as conventional retirement plans, which reduce the freedom of the employee trusts and employers to take the necessary steps to implement the plans, and which otherwise block the establishment and success of these plans.

Tax Reform Act of 1976 § 803(h).

221. See Hinson & DiCarlo, *supra* note 186, at 23 (discussing Congress' inclusion of employee owned stock under ERISA's prudence and loyalty requirements).

222. *Id.* The duty of loyalty creates an obligation for fiduciaries to act for the benefit of participants and beneficiaries. See ERISA § 404(a)(1).

223. ERISA § 404(a)(1).

224. See *Donovan v. Cunningham*, 716 F.2d. 1455, 1466 (5th Cir. 1983).

225. *Id.*

226. *Id.*

competing motivations, courts have interpreted the prudence requirement differently with regard to investments in employee stock in plans such as ESOPs.²²⁷ In turn, investments in employee stock may be considered a legitimate employee benefit plan, goal and objective, allowing investments in employer stock to be made even though they may not maximize the return on plan assets.²²⁸

Although ESOP fiduciaries are not exempt from ERISA's "prudent man" standard,²²⁹ they are free to invest in employer stock without having the requirement to diversify.²³⁰ Furthermore, a fiduciary who invests primarily in the employer's stock is entitled to a rebuttable presumption that he acted consistently with ERISA²³¹ and, generally, cannot be held liable for failing to diversify, regardless of whether diversification would have been prudent under the terms of a non-ESOP plan.²³² Fiduciaries are under a "duty of loyalty" so that all decisions made regarding the plan must be made in the interest of the participants and beneficiaries.²³³ However, even a duty of loyalty does not guarantee that the fiduciary will make all the right decisions.

In *Kuper v. Iovenko*, the court, which rendered its decision around the same time as the Third Circuit decided *Moench v. Robertson*, nar-

227. Hinson & DiCarlo, *supra* note 186, at 23. See also *Martin v. Feilen*, 965 F.2d 660, 665 (8th Cir. 1992).

228. See *Moench v. Robertson*, 62 F.3d 553, 568 (3d Cir. 1995).

229. Employee Retirement Income Security Act (ERISA) of 1974 § 404(a)(2), 29 U.S.C. § 1104(a)(1)(B) (2006).

230. *Moench*, 62 F.3d at 571. Although ESOP fiduciaries generally are not required to diversify, in certain circumstances, employees are given the option of diversifying their part of the plan. ESOP Association, *How Do ESOPs Work?* (2004) at http://www.esopassociation.org/about/about_work.asp (last visited Mar. 12, 2009) [hereinafter ESOP Work]. According to the ESOP Association, once an employee has 10 years of participation in ESOP and reaches age 55, he must be given the option of diversifying his ESOP account up to 25% of the value. *Id.* When the employee reaches age 60, he is given a one-time option to diversify up to 50%. *Id.* This requirement applies to ESOP shares allocated to employee accounts after Dec. 31, 1986. *Id.*

231. *Moench*, 62 F.3d at 571 (invoking trust law by stating that "[a]s in all trust cases, in reviewing the fiduciary's actions, the court must be governed by the intent of the trust—in other words, the plaintiff must show that the ERISA fiduciary could not have believed reasonably that continued adherence to the ESOP's direction was in keeping with the settlor's expectations of how a prudent trustee would operate"). See also Hinson & DiCarlo, *supra* note 186, at 24 (describing the intent of the plan sponsor as pivotal in deciding whether the fiduciary's decision to remain invested in employer securities was prudent or not).

232. *Kuper v. Iovenko*, 66 F.3d 1447, 1458 (6th Cir. 1995). But see Kevin C. Wynne, *The Forgotten Fiduciary Duty of ESOP Trustees*, 7 J. COMPENSATION & BENEFITS 234 (1991) (stating that "[i]f fiduciaries fail to make prudent investments, they have breached their statutory duty" and that "[w]here diversification is absent, the burden shifts to the fiduciary to justify his failure to diversify").

233. *Kuper*, 66 F.3d at 1458.

rowed the overly broad *Moench* holding that afforded a discretionary standard to the fiduciary in making decisions concerning employer securities.²³⁴ While the *Kuper* court adopted the Third Circuit's abuse of discretion standard, the court instead opted for a stricter view of the plaintiff's ability to rebut the presumption of reasonableness attached to the fiduciary's actions.²³⁵ As the Sixth Circuit stated in *Kuper*, "[d]espite this recognition that ESOPs place employee assets at a greater risk, the purpose of ESOPs cannot override ERISA's goal of *ensuring the proper management and soundness of employee benefit plans*."²³⁶ If, as the *Kuper* court states, the purpose of ERISA is to guarantee that an employee's benefit plan is sound, it appears that one way to do this would be to minimize the amount of risk on the plan investments, perhaps by either privately-owned or government-owned and -operated insurance companies.

It may seem comforting that the fiduciary responsible for a breach of duty, and subsequent losses for the participants' plan dollars, should be held personally liable for the losses that result from the breach.²³⁷ Despite the fact that the fiduciary remains personally liable, this does not completely solve the problems of employees who have lost their retirement savings to a mismanaged plan. Under ERISA, an individual is not allowed to personally recover for the breach of fiduciary duty, even if the individual is the one who brings the suit.²³⁸ Instead, any restitution that the fiduciary is required to pay is put back into the plan.²³⁹

The real risk to plan participants does not just arise from the fact that fiduciary may be personally liable, but rather the fact that the fiduciary may be insolvent. "Judgment-proof" fiduciaries is just one of the issues that is raised by holding fiduciaries personally liable. This would occur when the fiduciary is unable to pay the restitution owed, leaving employees with no way to recover the money that they lost. One potential solution to this problem is fiduciary liability insurance. There is a

234. See *Moench*, 62 F.3d at 571.

235. Compare *Moench*, 62 F.3d at 571 ("[I]n attempting to rebut the presumption [of reasonableness] . . . the plaintiff must show that the ERISA fiduciary could not have reasonably believed that continued adherence to the ESOP's direction was in keeping with the settlor's expectations of how a prudent trustee would operate."), with *Kuper*, 66 F.3d at 1459 ("A plaintiff may then rebut this presumption of reasonableness by showing that a prudent fiduciary acting under similar circumstances would have made a different investment decision.").

236. *Id.* at 1457 (emphasis added).

237. See Employee Retirement Income Security Act (ERISA) of 1974 § 409(a), 29 U.S.C. § 1109(a) (2006).

238. *Kuper*, 66 F.3d at 1452-53.

239. *Id.*

substantial amount of ERISA fiduciary responsibility insurance available on the market and much of it is offered at a reasonable price for the benefits afforded.²⁴⁰ One example of such insurance offers insurance for fiduciaries in the event that they are found to be in breach of their fiduciary duties.²⁴¹ The policy provides coverage to fiduciaries, the ESOP plan itself, and the plan sponsor.²⁴² However, the fiduciary insurance only provides coverage in the event of a claim of breach of fiduciary duty.²⁴³ Because the fiduciary insurance only provides coverage for breach of fiduciary duty, as long as the fiduciary was acting in the interests of the ESOP, the plan participants will not be able to recover their losses.²⁴⁴

IV. PROPOSAL—AN OLD IDEA, A NEW TAKE

“Insurance can be designed to protect employee shareholders against the possibility that the ESOP will not deliver the assets to which [the employees] are entitled.”
—Louis O. Kelso & Patricia Hatter²⁴⁵

It is an old idea, yet a good idea. The solution that we propose to combat the risks that are present within ESOPs is a type of insurance that would cover the ESOP in the event that the company's stock falls below a certain threshold value. This insurance would establish a floor amount of coverage for ESOP participants. In other words, the insurance would only become effective if the stock drops below a threshold

240. Johanson, *supra* note 196 and accompanying text. See generally Professional Insurance Associates, *supra* note 209 (discussing specific details of a fiduciary liability insurance policy offered by the Chubb Group of Insurance Companies).

241. *ESOP Fiduciary Insurance*, *supra* note 196.

242. *Id.* The Fiduciary Liability Policy provides coverage to past, present, and future fiduciaries. *Id.* In this context, fiduciary refers to any person who (1) exercises any discretionary authority or control in the management or disposition of its assets; (2) renders investment advice for a fee or other compensation; or (3) exercises any discretionary authority or responsibility for plan administrators. *Id.* In providing coverage for the plan and the plan sponsor, the policy provides coverage directly to the trustees individually or the sponsor in the event that the sponsor has to defend the trustee in a lawsuit. *Id.*

243. *Id.*

244. See generally *id.* (explaining the claim must allege a breach of fiduciary duty). If no such breach is found, then plan participants will not prevail on their claim and plan participants, obviously, will not recover on that claim. Minimum limits of liability for such a policy are generally \$1,000,000. *Id.*

245. Louis O. Kelso & Patricia Hatter, *Employee Stock Ownership Plans: A Micro-Application of Macro-Economic Theory*, 26 AM. U. L. REV. 521, 530 (1976).

level, or in the event that it becomes worthless.

ESOPs are still, and still would be, considered under the umbrella of defined contribution plans, despite the fact that they would potentially take on the appearance of pseudo-defined benefit plans. While the insurance would still not be able to guarantee a rate of return or make the stock plan similar to a defined benefit plan, it would afford ESOP participants one of the protectionist guarantees afforded to defined benefit plans, hence eliminating a significant amount of the risk. The fiduciary would still remain responsible for acting in the best interest of the plan. That, coupled with insurance protection, could allay the fears of many employees hesitant about the risks involved with ESOPs.

Due to the success of most ESOPs, the performance and return on the employees' stock would be well above the level at which the insurance would become necessary. Because the insurance would only be activated when the business goes bankrupt or their stocks fall below a predetermined level, the overall cost of implementing such a system would not be overwhelming. Another alternative mechanism which would trigger the insurance benefits would be the default on the loan which was utilized to purchase the ESOP stock in the first place. By providing additional benefits, and securing more instances which could leave participants vulnerable, the insurance plan becomes more feasible.

In order to avoid the problems that the PBGC, a government-administered insurance provider, has encountered, we believe that this type of insurance is best handled by a private insurer. J. Michael Keeling, President of the ESOP Association, speculates "that the leadership [of the ESOP Association], through [its] Board of Directors would balk at a government program modeled after the PBGC, which is quickly proving to be on as shaky grounds as the Social Security system despite [defined benefit] plan sponsors having to pay the PBGC money in the form of taxes."²⁴⁶ A private insurer would be the most efficient method of implementing such an insurance program because of their ability to focus on the most effective way to insure the ESOPs, without the concerns of big government bureaucracy.

A private body would be better equipped, with funds, manpower, and absence of red tape, to accommodate all of intricacies of establishing and efficiently running an ESOP insurance program. One major concern that could be avoided by private insurance, as opposed to government funded insurance like the PBGC, would be that a private insurer(s) could determine the most efficient number of ESOPs to insure. A government-

246. Letter from J. Michael Keeling to the authors of this Article (on file with authors).

funded insurance format would have to insure all companies, which may not be the most efficient method of insuring ESOPs. By being able to selectively choose to insure some ESOPs and not others, based on a set of criteria for acceptance-denial or a graduated premium rate structure, the ESOP insurer would best be able to protect its business while ESOP sponsors would have more of an incentive to keep their business working at its optimal level. Another potential benefit is that private insurers would be able to specialize on the type of ESOP insurance that they provide. Some private insurers could focus on smaller ESOPs, perhaps under fifty or a hundred employees, while others could focus on larger plans. This type of specialization would ensure the most efficient results because of the ability to design insurance more specific to the needs of the type of company utilizing the insurance. The risks and problems associated with companies of certain sizes and their associated ESOP plans could be more individually tailored by specialized ESOP insurers.

In addition to the insurance being a private venture, it would need to be mandatory for all companies who have ESOPs. Making the insurance mandatory would help combat the moral hazard and adverse selection problems.²⁴⁷ A required insurance policy would help to keep the costs down, or at least keep costs consistent among employers that utilize ESOPs as an investment plan or retirement device. If all ESOPs were made to pay premiums, like any insurance program, the risk would be spread out over all parties that have the possibility of acquiring its benefits. There would not be a stigma attached to having such an insurance, as it would be a requirement to starting and maintaining such a retirement benefit for employees.

A. Advantages and Benefits of ESOP Insurance

There is a great deal of upside potential for an insurance program to cover ESOPs. The benefits obtained from ESOP insurance would serve to benefit both participants and plan sponsors by increasing the strength, stability, and risk associated with plans that are so dependent on the will of the market.

1. Limitation of Investment Risk

The main benefit of ESOP insurance would be that “it could help to limit the investment risk associated with investments in company stock

247. See discussion *infra* notes 275-326 and accompanying text.

and prevent the adverse circumstances that many publicly-traded companies and their ESOP participants experienced during the early part of the turn into the [twenty-first] century.”²⁴⁸ As discussed above, there are a number of risks involved when an employee is primarily investing in the employer’s stock.²⁴⁹ If the company were to go bankrupt, not only would the employee lose his job, but he would lose much, if not all, of his retirement benefits as well.²⁵⁰

2. Expansion of the Use of ESOPs as Vehicles of Retirement Benefits

A second major benefit of an ESOP insurance would be that insurance would help to expand the development of ESOPs. As Mr. Keeling has pointed out, “[i]f employee ownership is going to increase . . . the conflict issues have to be addressed.”²⁵¹ The conflict Mr. Keeling is referring to is that, on one hand, under ERISA, the fiduciary must manage the plan solely to benefit the members.²⁵² On the other hand, the purpose of the ESOP is to invest “solely in the shares of a single company.”²⁵³ These two requirements can never be completely reconciled.²⁵⁴ Consequently, the portfolio is non-diversified and high risk—“the worst possible design for a retirement vehicle.”²⁵⁵ By insuring the ESOP, much of this risk would be reduced. This reduction in risk would alleviate some of the conflict because the plan would be insured to a point and the plan’s fiduciary would be able to invest solely (or almost solely) in the company, while still working in the best interests of the plan’s members.

Employees contemplating investment in an ESOP would be further convinced of the legitimacy and propriety of their investments and the fiduciary’s ability to properly manage their assets if an insurance plan is in place. If employees were assured of the increased safety of their investments, ESOPs would become a more popular vehicle of retirement savings. While these plans are becoming increasingly popular and present in the public eye, the protection offered by insurance could only

248. This comment was made by David Johanson, a partner at Johanson Berenson LLP, in a letter to the authors of this Article (on file with authors).

249. See *supra* note 201 and accompanying text.

250. Maggs, *supra* note 201, at 50.

251. Frieswick, *supra* 22, at 75.

252. *Id.* at 74.

253. *Id.*

254. *Id.* at 75.

255. *Id.* at 74.

serve to heighten their attractiveness to employees.

3. Increased Awareness of Risks of ESOPs and Other Retirement Plans

A third advantage of a mandatory insurance plan would be the increased awareness of the risks and potential pitfalls of retirement plans in general. In general, people are not nearly as informed as they should be about who is handling their retirement savings and what is being done with them. An insurance plan would bring increased knowledge and scrutiny to retirement plans which focus on something as risky as stock. People would be more apt to look closely at where they are putting their money and evaluate whether this is the best retirement vehicle for them. As acknowledged by David Johanson:

When ESOP participants receive the proper education regarding such investments and understand the connection between their personal work efforts, the collective efforts of all ESOP participants, net income and the fair market value of company stock, an ESOP can produce substantial investment returns for ESOP participants with a reasonable amount of investment risk.²⁵⁶

As this statement demonstrates, ESOPs can be a wonderful way for employees to save for retirement, but the employees must also be educated about how ESOPs work and the risks inherent in their structure. Although obviously not the main focus of ESOP insurance, one additional benefit could quite possibly be that the insurance will open the employees' eyes to the risks they potentially face in this non-diversified investment. Unfortunately, Jimmy Allen was not prepared for his company's ESOP to become worthless, but it is not too late to help educate others who might face similar situations in the future.²⁵⁷

4. Closing the Gap Between ESOP Shareholders and Regular Shareholders

Insurance would be a safety net against the little-known fact that ESOP members do not have as much control over the value of their

256. David Johanson, a partner at Johanson Berenson LLP, made this comment in a letter to the authors of this Article (on file with authors).

257. See Kesmodel, *supra* note 1, at 6C (describing the personal consequences for Allen's when his pension was reduced by 70%).

stock as a “regular shareholder” of the company.²⁵⁸ Although ESOPs are often praised as a vehicle for employee ownership, “the notion that an ESOP creates employee owners may be misleading, and is still an unsettled issue.”²⁵⁹ Instead of actually having ownership of the stock, and the voting rights that accompany it, “employees in ESOPs are considered ‘beneficial owners.’”²⁶⁰ While a “regular shareholder” can vote or sell his stake in the company, employees have very little control in the way of ownership because they cannot control how their shares are voted.²⁶¹ The responsibility of voting the shares falls on the trustee,²⁶² not the plan participants who will eventually depend on the value of the shares for their retirement. The final decision concerning the disposition of shares is at the discretion of the trustee, who may or may not do as the ESOP members direct.²⁶³ Because the plan participants have no control over how their shares are voted, ESOP insurance would be one way in which they can be sure that their investment will give them a return, at least at some minimum level.

B. Potential Criticisms of ESOP Insurance

A number of arguments can be made against the likelihood of success of an ESOP insurance program. Though the simplicity and necessity of the benefits may seem to outweigh the potential costs and consequences, there are a number of questions regarding the feasibility of, and probability of proper functioning of, such an insurance plan.

1. Cost

When we asked several ESOP experts²⁶⁴ for their thoughts on insurance, the most common criticism was the idea that “the cost of such

258. See Frieswick, *supra* note 22, at 74 (noting that employee members are “considered ‘beneficial owners’ of the stock, as they have limited control over how [the ESOP] stock is voted”).

259. *Id.*

260. *Id.*

261. *See id.*

262. *Id.* This is not always the case, however, as there are many exceptions to this rule. Plans are able to list certain situations in which the employees can vote the stock. *Id.*

263. *Id.*

264. We greatly appreciate the helpful comments that we received. The three experts who were kind enough to offer their thoughts on the subject of ESOP insurance are: Corey Rosen, Executive Director of the National Center for Employee Ownership (NCEO); David R. Johanson, a partner at Johanson Berenson LLP; and J. Michael Keeling, president of The ESOP Association.

insurance would be prohibitive.”²⁶⁵ J. Michael Keeling said that either way the insurance is financed, whether it be government- or privately-funded, the overall cost may be a barrier to its success.²⁶⁶ Mr. Keeling stated that “a government program would be mandatory tax increases, and in a sense lower the value of the company stock in the ESOP. A private voluntary system would be premium costs that many legal and financial experts would argue are better put to use invested in something other than insurance.”²⁶⁷

The cost of implementing an insurance system, private or government-run, would be dependent on (a) the likelihood of having to pay out (i.e., the stock falling below a certain threshold value, etc.); (b) administrative costs (i.e., hiring actuaries to determine premium rates, etc.); and (c) a certain premium for uncertainty. The uncertainty premium would likely be based on the notion that the insurer could not confidently assess a company due to lack of knowledge of what the company may do in the future or just the general nature of market activity. However, while this uncertainty would be thought to cause a dramatic increase in the potential levels of insurance premiums, this would not actually be the case. At least for publicly owned companies of considerable size, somebody is already assessing and valuing these same companies that will be sponsoring ESOPs—rating agencies. Rating agencies have the job evaluating the risk of companies, oftentimes in regards to debt issuance.²⁶⁸ In that respect, some of the cost will be eliminated, as the valuation and assessment of these companies has already been performed for other purposes.²⁶⁹

In addition, if ESOPs are as successful as most experts claim, there should be sufficient funds from which to pay the premiums.²⁷⁰ As long as the company is stable and has a low risk of bankruptcy, there is no

265. Letter from David R. Johanson to the authors of this Article (on file with authors).

266. Letter from J. Michael Keeling to the authors of this Article (on file with authors).

267. *Id.*

268. See Progressive Auto Insurance, *Financial Strength & Debt Ratings*, at <http://investors.progressive.com/ratings.asp> (last visited Apr. 3, 2005); Moody's, *Introduction to Moody's: Moody's Role in the Global Capital Markets*, at <http://www.moody's.com/moodys/cust/AboutMoody's> (last visited Apr. 3, 2005); Standard & Poor's, RatingsDirect, *Rating Definitions and Terminology* (Mar. 18, 2003), available at www.standardandpoors.com/ratingsdirect (last visited Apr. 3, 2005).

269. Rating agencies may not have risk evaluations of smaller or privately-owned companies.

270. See generally M. Richard Vinocur, *The Advantages of Employee Ownership*, AM. PRINTER, Sept. 1, 2004, at 6 (discussing the success of a graphic-art distribution company's ESOP); Karen D. Ng, *Employee Benefits: ESOP – The Misunderstood Plan*, 26 SAN FRANCISCO ATT'Y 17, 17-18 (2000) (discussing the ESOP as a “tool of corporate finance” that allows a company to maintain a higher cash flow).

reason why the ESOP insurance premiums need to be prohibitively high. Depending on how the insurance is set up, costs may vary between companies, or may be quite small for all employers. Employers currently pay premiums on any defined benefit plan covered by the PBGC;²⁷¹ ESOP insurance would simply extend the ability (or responsibility) for employers to pay a fee in order to ensure that their ESOP will also be able to provide a comfortable retirement for their employees. As long as the plan is structured in a reasonable way, such as guaranteeing a floor amount or a fixed amount per month, there seems to be no reason why the costs of the insurance cannot be calculated and brought to a reasonable level like other forms of insurance.

2. Moral Hazard Problem Generally

With any insurance plan comes the problem of moral hazard.²⁷² Insurance is primarily thought of as a tool for spreading risk among plan participants and reducing the risk to the insured.²⁷³ The probability of severe losses is cut down by the alteration of the financial consequences of each of the parties involved.²⁷⁴ However, due to the very nature of the risk-spreading mechanism inherent in insurance coverage, there is a disincentive to take due care to prevent accidents or mismanagement.²⁷⁵ Since the insured participants have the ability to transfer the costs of the accident or mismanagement to other participants in the plan, there is less of an inclination for loss prevention or the mitigation of potential consequences of the accident or mismanagement after it occurs.²⁷⁶ The presence of insurance may even encourage those insured by the plan to increase the likelihood of an accident so that they may recover the proceeds of the insurance.²⁷⁷ This problem of perverse incentives is known as “moral hazard.”²⁷⁸

The insurance industry utilizes various mechanisms to alleviate moral hazard and encourage the proper use of the insurance.²⁷⁹ Insurers

271. See generally Daniel Keating, *Pension Insurance, Bankruptcy and Moral Hazard*, 1991 WIS. L. REV. 65, n.21 (1991) (“[A] [defined benefit plan] sponsor’s obligation is not fulfilled until the participant’s benefits are paid fully or an annuity is purchased on behalf of the participant.”).

272. RICHARD C. HULA, ed., *MARKET-BASED PUBLIC POLICY*, 28 (1988).

273. *Id.*

274. *Id.*

275. *Id.*

276. *Id.*

277. *Id.*

278. *Id.* See Keating, *supra* note 271, at 67-68.

279. HULA, *supra* note 272, at 28.

often use deductibles,²⁸⁰ co-insurance,²⁸¹ limits,²⁸² and merit-rating to assure that the system is not unfairly taken advantage of.²⁸³ Merit rating involves setting premiums that are in proportion to the risk involved in the situation, normally a method where the premium paid is correlated to the risk involved.²⁸⁴ A merit-rating system would be most advantageous in assuring that an ESOP insurance plan functioned to spread risk proportionately among parties.²⁸⁵ Though the insurance industry must take into account the market structure and obtain a full risk analysis before employing such a strategy, this type of insurance would be new to the industry.²⁸⁶ As of right now, there would be no legal constraints on this type of system, as this type of insurance does not exist in the marketplace.²⁸⁷

An ESOP insurance plan is potentially feasible in both a government-regulated situation or in a private setting.²⁸⁸ In a commercial setting, such as with ESOPs, insurers have more freedom to set their rates, priorities, and premium schematics than do government systems.²⁸⁹ Similar to fire or automobile insurance, this is the type of situation where competitive pressure for merit-rating works best.²⁹⁰ In some situations it may be difficult to ascertain the exposures faced by an ESOP. However, in such a scenario, the company's financial situation and business prospects may be helpful in classifying such risk expo-

280. *Id.* Deductibles require the insured to partially pay for the "first-dollar" of losses. *Id.*

281. *Id.* Co-insurance is a mechanism whereby the insured is responsible for some proportion of the losses sustained that is somewhere between the "floor and ceiling" of insurance coverage. *Id.*

282. *Id.* Limits serve the purpose of reducing the desire to create a loss on an "overvalued exposure." *Id.*

283. *Id.*

284. *Id.*

285. A similar system in place—the PBGC—does not adequately provide for merit-rating, as its premiums are not adjusted to the risk inherent in the situation. *See infra* notes 301-09 and accompanying text.

286. *See* HULA, *supra* note 272, at 29.

287. *See supra* notes 196-244 and accompanying text. Some types of insurance premiums are regulated by legalized cartel agreements, such as ratings bureaus that have the express purpose of cutting down competitive pressure to analogize premiums to risks. *Id.* Other types of insurance choose not to equate premiums with risk in efforts to make the insurance affordable for certain groups, and in effect, giving subsidies. *Id.* Currently ESOPs are not covered under PBGC protection, as they are considered a defined contribution plan. Keating, *supra* note 271, at 69 & n.21. No private insurers currently carry a policy that protects ESOP participants. The only insurance available is for ESOP fiduciaries. *Supra* notes 240-44 and accompanying text.

288. Commercial insurance lines have more freedom to set their rates, priorities, and premium schematics than do government systems. HULA, *supra* note 272, at 29.

289. *Id.*

290. *Id.*

sure.²⁹¹ A merit rating such as this, which would examine a number of factors, would potentially have a large initial cost. However, over time, the costs could potentially be amortized as a deferred expense because it might be considered a start-up expenditure.²⁹²

Insurers have the option of utilizing different methods to differentiate their merit rating.²⁹³ This differentiation occurs up until the point where “the marginal gains from differentiation equal the marginal cost of gathering additional information.”²⁹⁴ The merit rating may be differentiated by classification. Classification involves charging premiums based upon identifiable and verifiable attributes that have a strong correlation with an expected loss.²⁹⁵ A classification system would work well with ESOPs, since the current lack of diversification in ESOPs could be construed as a controllable trait in the sense that it has been proven that a lack of diversification has a negative impact on the inherent risk and return of a portfolio.²⁹⁶ Also, the diversification could be construed as controllable, as Congress at any time could pass a law requiring that ESOPs be diversified. In this type of scenario, merit rating would provide incentives to reduce risk.²⁹⁷

Another method of merit rating which might potentially work with ESOP insurance plans is a system whereby each individual company’s business prospects and company situation is taken into account.²⁹⁸ In the case of ESOPs, the company providing the ESOP would be examined, analyzing its current pension plans, probability of insolvency, diversifi-

291. Loss experience would probably not be available since an enormous loss could potentially put the company out of business.

292. I.R.C. § 195(b)(1), (c)(1)(B) (2006).

293. These methods of differentiation become necessary to prevent competitive pressures between carriers that charge a uniform rate versus those carriers that charge a lower rate. Such a system prevents an adverse selection problem. HULA, *supra* note 272, at 29-30.

294. *Id.* at 30.

295. *Id.* An example involving male and female drivers explains the concept more clearly:

For example, young, male drivers are charged higher automobile liability rates than middle-aged female drivers. Such classification schemes do not reward an insured for a better-than-class record. To the extent that rates are based upon traits like age and sex, which are ascribed and uncontrollable, the incentives for risk reduction are weak. For example, if premiums for teenage boys are so high, they may wait till they are older to obtain their driving license; however, they may begin driving without either a license or insurance. *Where classification is based upon controllable traits, such as a certificate from a “defensive driving” school, merit rating provides incentives for risk reduction.*

Id. (emphasis added).

296. WILLIAM W. BRATTON, CORPORATE FINANCE: CASES AND MATERIALS 94-96 (5th ed. 2003).

297. HULA, *supra* note 272, at 30.

298. *Id.*

cation of the plan, and previous problems with default and pension asset mismanagement. Combining classification data with individual company's loss experience and prospects would provide a more accurate rate setting for the insurance plan, and cut down on the moral hazard dilemma.²⁹⁹ Obtaining correct data would be crucial, as well as utilizing this data effectively.³⁰⁰

3. Moral Hazard Problem in Relation to the PBGC

The feasibility of ESOP insurance might be questioned due to the marked similarities between ESOP insurance and the current coverage provided by the PBGC. Due to the recent problems of the airline industry, the future of the PBGC, and the coverage that it provides to many pension plans, continues to be a large concern of pension plan providers and the government agency that secures them.³⁰¹ However, there are tremendous differences between the moral hazard problem inherent in the ailing PBGC and its solvency problems and that of the potential problems of ESOP insurance.³⁰²

In November of 2004, the PBGC announced that its potential liabilities far exceed its assets—to the tune of \$23.3 billion.³⁰³ With scant contributions being made to the PBGC, there is nowhere near enough money to cover the potential payouts of the PBGC and emerge from their current deficit.³⁰⁴ The PBGC's deficit has risen nearly twenty-fold

299. A scoring methodology would have to be created which correctly and efficiently takes into account the insured's attributes and brings together these factors into a single score. *Id.*

300. *Id.*

301. See Emily Heil, *Pension Agency Reports a Doubling of its Deficit in FY04*, CONGRESS DAILY, Nov. 15, 2004. See also Steve Forbes, *Pauperizing Pension of Last Resort*, FORBES, Oct. 4, 2004, at 34 ("underfund-ing for corporate pension plans as whole exceeds \$300 billion").

302. See *infra* notes 322-23 and accompanying text.

303. *Do You Know Where Your PENSION Is?*, KIPLINGER, Feb. 2005, at 24, available at www.kiplinger.com/magazine/archives/2005/02/benefits.html (last visited Jan. 14, 2009). See Jerry Geisel, *Reforms Seek to Shore Up PBGC*, BUSINESS INSURANCE, Jan. 17, 2005, at 1.

304. Geisel, *supra* note 303, at 1. It is likely that if the financial health of the PBGC continues to deteriorate, taxpayers will be forced to bail out the agency and make up for the shortfall. *Id.*; see Forbes, *supra* note 301, at 34 ("The PBGC has gone from a surplus of nearly \$10 billion in 2000 to a deficit of \$11 billion last year. The shortfall could balloon to \$50 billion or more if likely-to-fail plans actually bite the dust."); see also *Airline Plans' Underfunding Illustrates Broader Problems with the Defined Benefit Pension System: Hearing on Private Pensions Before the S. Comm. On Commerce, Science, and Transportation*, 109th Cong. (2004) (statement of, David M. Walker, Comptroller General of the U.S.) ("As I have noted in recent testimonies before several congressional committees, we believe the single-employer program's long-term ability to sustain itself as a self-funded entity is at risk in its present form. Given the structural problems facing the agency, in July 2003, GAO placed the PBGC single-employer pension program on our 'high risk' list of trou-

since 1994, due to the failure of a number of steel manufacturers; this was the last time Congress substantially altered its pension funding rules.³⁰⁵ This scenario can only get worse if no help is given to this ailing agency, by way of a bail-out or reform of the agency and legislation.³⁰⁶

The moral hazard problem, in relation to the PBGC, exists due to the number of underfunded pension plans.³⁰⁷ Many of these single-employer pension plans have suffered a decline in the value of pension assets, due mostly to a decline in stock prices, which in turn has hindered the ability of these plans to pay pension benefits.³⁰⁸ In addition, declining interest rates inflated the value of the pension liabilities.³⁰⁹ The combined effect of these negative occurrences was (and is) that many pension plans have insufficient resources to pay the benefits which they have promised to their participants.³¹⁰ Though a declining stock market and falling interest rates are only temporary factors, other market trends, such as a declining number of defined benefit plans, a decline in the percentage of participants who are active workers, and a rise in alternative savings vehicles, such as ESOPs, have threatened the viability of the current PBGC structure.³¹¹

The PBGC's assumption of responsibility for underfunded pension plans has to do with a lack of incentive for companies to properly fund their pension plans and have appropriate coverage.³¹² The PBGC's current premium rate structure does not accurately take into account the respective risk of each company that it insures.³¹³ It does not adequately take into account the plan sponsor's financial condition, the nature of the portfolio held by the pension plan, and the structure of the benefit provisions.³¹⁴ This poor correlation between risk and premium partially accounts for the financial woes of the PBGC, and their inability to be fully

bled federal programs in need of ongoing attention by the Congress.”).

305. Geisel, *supra* note 303, at 1; *see also* Walker, *supra* note 304 (noting that “[o]f the 10 most underfunded pension plan terminations in PBGC’s history, 5 have been in the steel industry . . .”).

306. Geisel, *supra* note 303, at 1.

307. Walker, *supra* note 304.

308. *Id.*

309. *Id.*

310. *Id.*

311. *Id.*

312. *Id.*

313. *Id.*; *see also* Geisel, *supra* note 303, at 1 (stating that proposed legislation would work towards having the current \$19 a year per plan participant rise to \$30, with increases to follow based on a link to national growth in workers’ wages).

314. Walker, *supra* note 304.

able to fund the pension plans upon their demise.³¹⁵

However, the structure of the PBGC allows for this moral hazard incentive to bring it down even further.³¹⁶ Pension plan sponsors often place other financial priorities above adequately funding their pension plans, knowing that the PBGC is guaranteed to pay out benefits up to a certain amount.³¹⁷ Some companies even go so far as Chapter 11 bankruptcy to avoid paying their pension obligations.³¹⁸ The result ends up being that pension plan sponsors that find themselves in a dire financial situation may be more apt to underfund their plan, taking advantage of the potential for the PBGC to pick up their slack and pay a certain amount of guaranteed benefits.³¹⁹ This type of behavior is symptomatic of a “vicious cycle of bankruptcies and plan terminations,” as these companies use the PBGC coverage of ridding themselves of a liability that they have neither the assets nor the ability to deal with.³²⁰ The PBGC is viewed as a “fallback” or “put option” for financial help when things go awry, creating a perverse incentive for plan sponsors to shirk their responsibilities.³²¹

The moral hazard problem encountered by the PBGC is not indicative of the problem that would be encountered by an insurance plan covering ESOPs. Coverage by the PBGC is exclusive to defined benefit plans, as laid out by the ERISA statute, whereas ESOPs fall within the realm of defined contribution plans.³²² Whether a public or private form of insurance was structured for the coverage of ESOPs, the plan could be designed to take into account the moral hazard problems which are currently causing tremendous harm to the PBGC. A newly-constructed system would be better able to take into account the risk encountered by the PBGC, and make sure that premiums reflect the incentives, transparency, and accountability necessary in such a system.³²³ The implemen-

315. *Id.*

316. *Id.*

317. *Id.*

318. *Id.*

319. *Id.*

320. *Id.*

321. *Id.*

322. *See* Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. §§ 1001 – 1461 (2005).

323. *See* Walker, *supra* note 304. The pension plan providers must have incentives in order to properly fund their pension plans, otherwise, a situation similar to the one with the PBGC will be apt to occur. Along the same lines, there must be adequate transparency for the plan participants, including information about the plan itself and what to do in the case of a failing plan. Accountability, with respect to plan fiduciaries, would be key to the formulation of an effective insurance plan. *Id.*

tation of specific points of time when plan benefits would come into play, an overall evaluation of plan underfunding and bankruptcy situations, and a close examination of plan assets, with the potential to require some type of diversification to even acquire insurance, would help to ensure that the moral hazard problem evident in the PBGC coverage is not a sign of things to come with an ESOP insurance program.

4. The Negative Message That It Sends

An ESOP insurance plan could potentially be criticized for the message that it sends to those investing in the pension plan as to the health and viability of the plan. The requirement of the insurance may lead possible investors to believe that the corporation does not have the assets, nor the confidence in their stock, to feel comfortable with their ESOP.

The requirement of mandatory ESOP insurance could avoid the problem of negative image and portrayal.³²⁴ Mandatory insurance takes away the argument that the presence of the insurance is a tell-tale sign of the plan's poor health. No longer would the insurance be considered a foreboding sign of ailment, but instead, an extra measure of protection to give the ESOP participants the sense of safety and longevity that future retirement benefits should.

By having insurance coverage be required, the argument that healthier ESOP plans would be at a detriment to more feeble, underfunded plans would have little basis. With a risk-based premium structure, and more care and effort being devoted to tailoring the insurance to the needs of the company, better-funded ESOP plans would bear a proportional share of the risk as compared to their more risky counterparts. While more risky ESOPs might receive a significant amount of payout in terms of insurance benefits, they will be putting in more premiums based upon the riskiness of the stock and lack of diversification.

CONCLUSION

This Article argues that utilizing insurance to safeguard ESOPs is an efficient and effective way to regain trust in a retirement system which has lost popular approval and backing in recent times. As the current state of corporate affairs in America continues to be fraught with

324. Insurance would be mandatory for all ESOP participants, regardless of the fiscal health of their plan.

stories and examples of management distrust and underhanded dealings, the employees and investors need to be provided with some sense of security and protection. By implementing a system of insurance, ESOPs will be able to provide the best of both worlds—a retirement plan that offers unlimited upside potential from stock increases and decreased downside risk from a mitigation of the possible harm from fiduciary misconduct and company bankruptcy.

ESOPs have the ability to offer many benefits to both their employees and their sponsors, and insurance is a way to maximize both of these potential benefits. Because ERISA does not provide the utmost in protections to ESOP plans, there needs to be an outside influence in order to better the protections available to those employees that only have access to these types of retirement plans. In the past, the PBGC has offered coverage to defined benefit plans, but the time has come to alleviate some of the overwhelming risk apparent in defined contribution plans. While all of the risk inherent in defined contribution plans will never be eliminated, as that is the essence of these plans, ESOPs are an extremely risky type of plan that falls within the defined contribution plan realm and deserve to be protected.

Private insurers currently have fiduciary liability insurance to curb the potential loss of employees who have been harmed as a result of fiduciary misconduct. This protection is not enough. A system of private insurance for ESOPs would further allay the very realistic fears of employees that their stock may fall to a low or nil value. There are many ways for a company's stock to plummet at a moment's notice, and an insurance plan would serve to combat more than just the few situations that fiduciary liability insurance covers.

At this point in time, change is only possible if private insurers and the legislature agree to a system of mandatory insurance for ESOPs to prevent some of the problems that have become evident with these plans over time. Stories of ordinary people losing their retirement savings, like Jimmy Allen,³²⁵ will continue to surface if nothing is done to remedy the problems that arise with ESOPs. It is only when a system is formulated, where ESOPs garner some type of protection by way of private insurance and government-backing, that these retirement plans will reach the level of security and esteem of defined benefit plans.

325. See Kesmodel, *supra* note 1, at 6C.