EMPLOYEES STOCK OWNERSHIP PLANS (ESOPS) AND ACCOUNTING FOR PENSIONS

Marc Massoud, Claremont McKenna College, 500 E. Ninth Street, Claremont, CA 91711, 909-607-3203, marc.massoud@claremontmckenna.edu

ABSTRACT

An employee stock ownership plan (ESOP) is an employee benefit pension plan that invests primarily in the common stock of the employer company. An ESOP is a legal entity separate from the sponsoring company and is created by a trust agreement. The sponsoring company contributes to the ESOP shares of stock, or cash which is used to purchase the company's stock. Employees have an ownership interest in the stock, but actually they will receive their money when they leave the firm, due to retirement or otherwise. The cash that employees receive is raised by the ESOP from selling shares.

Stocks contributed to or purchased by the trust are allocated to the accounts of employees who have met certain eligibility requirements – like having worked for the company for at least three years. ESOPs are subject to vesting like private pensions. Plan enrollees are not taxed on the income earned by the plan, on contributions to the plan, on employee stock, or on other amounts added to their accounts until the time of distribution. So ESOPs enable employees to gain a tax-free ownership stake in their company.

Why Companies Establish ESOPs?

ESOPs are attractive to employer companies for three reasons:

1. ESOPs have considerable tax advantages.
2. ESOPs can provide a source of low-cost debt financing for the firm.
3. ESOPs have been used for a variety of purposes such as management buyouts and as part of a takeover defense.

Employees' payments into the ESOP trust are tax deductible within certain limits. The employer company can contribute its own stock to the ESOP and take a tax deduction for the fair value of the stock contributed. Similarly, dividends payments on shares held by the trust are also tax deductible.

Sometimes, the ESOP borrows cash from a financial institution to buy shares from the employer company. This is called a leveraged ESOP. The company makes payments to the trust to repay the principal and interest on trust borrowing, both payments are tax deductible.

Figure 1 illustrates the relationships between the ESOP, employer company, employees, and external funding sources like banks.

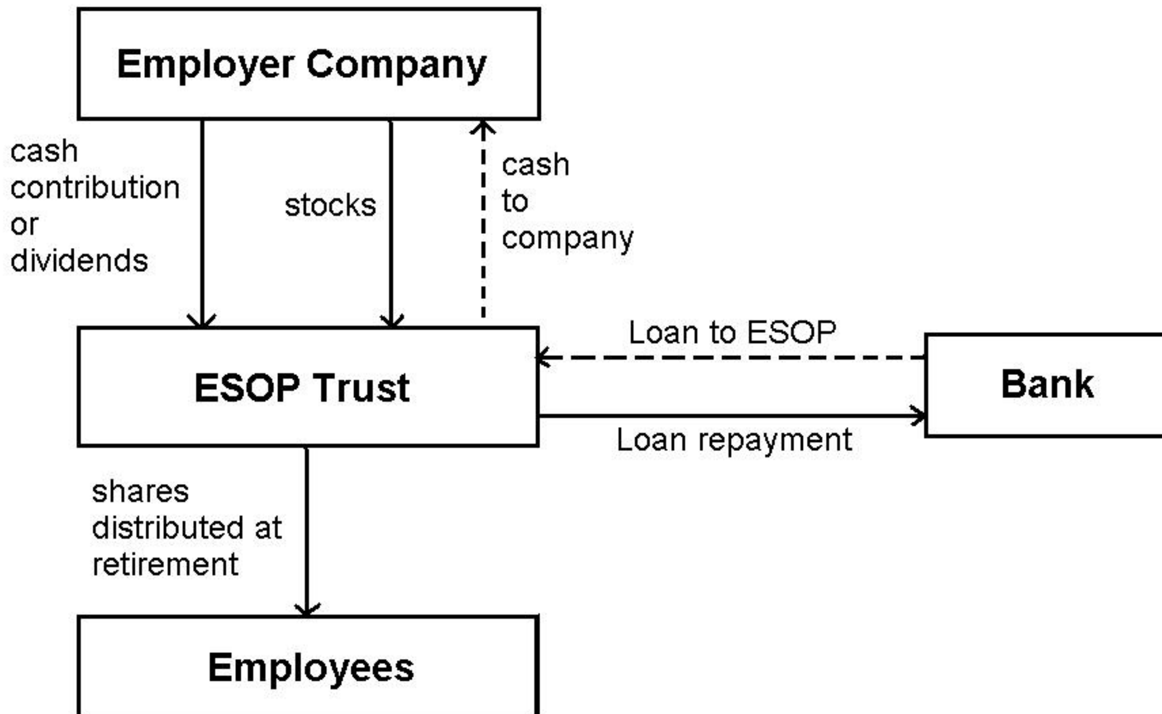

Figure 1

Apart from these tax advantages ESOPs have been used to take companies private, to acquire divested subsidiaries or divisions, to provide takeover defenses, and to save failed companies. ESOPs were initially used in 1990s as takeover defense since ESOP shares are impervious to buyout by a hostile acquirer.

The Dual Features

In the wake of the bankruptcies of Enron, United Airlines, and Polaroid, ESOPs have come under intense media scrutiny. The staggering losses of employees' retirement savings have promoted many politicians to call for regulatory overhaul.

The ESOPs are retirement plans covered by the Employee Retirement Income Security Act of 1974 (ERISA). Under ERISA requirements, the trustee must manage the plan for the sole benefit of the members and to preserve the value of the plan assets. But this flies in the face of the plan's mandate: to invest solely in the shares of a single company.

Such a non-diversified, high risk portfolio is considered the worst possible design for a retirement plan. In addition, the notion that an ESOP creates employee-owners may be misleading, and is still an unsettled issue. Some experts argue, although employees in the ESOPs are considered "beneficial owners" of the stock, they have limited control over how the stock is voted. Only the trustee is authorized to vote the ESOP shares. Thus, the final decision on the disposition of shares can fall to the trustee, which may or may not do as the ESOP members direct. This was the case in both Polaroid and United ESOPs in which plan members vehemently protested the trustees' decision to sell shares, arguing

that it was crucial that the employees maintain some ownership stake to have a voice during bankruptcy proceedings.

However, many experts argued that the trustee's mandate – to preserve plan assets – legally trumps all considerations including an employee's desire to maintain ownership of the stock.

Another fundamental conflict of ESOPs came to light in the Polaroid and United cases. Trustees at both companies effectively terminated the ESOP by selling its shares, however terminating a plan should be a management decision, and not a trustee decision. The trustee in the two cases used Enron as a good example. When the trustee failed to terminate the plan, days later the plan became worthless.

The conflicts don't end there. Once a company is in bankruptcy, the desires of company auditors, the company itself, and ESOP shareholders often quickly clash. United creditors and executives tried to block the trustee from selling ESOP shares after the company declared bankruptcy – partly because United feared a change in control, partly because it needed ESOP – related tax breaks for its post-bankruptcy success.

Some changes are needed!

As FASB and the Congress both are looking at pensions and employees' retirement plans, it is the right time to reconsider whether ESOPs should fall under ERISA given their dual goals. Preserving retirement benefits and holding an ownership position are in conflict over the long run.

In 1985, President Reagan recommended removing ESOPs from ERISA. The Congress blocked the move.

In April this year, Rep. Ballinger (R-NC) proposed HR1788 which calls for a presidential commission on employee ownership to review the inherent conflicts and regulatory and policy positions of federal agencies that often hinder the creation of ESOPs.

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