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ESOP's Failures: Fiduciary Duties When Managers of Employee-Owned Companies Vote to Entrench Themselves

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ESOPS' FAILURES: FIDUCIARY DUTIES WHEN MANAGERS OF EMPLOYEE-OWNED COMPANIES VOTE TO ENTRENCH THEMSELVES

Brett McDonnell*

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An ESOP Fable

Managers, Inc.'s workers own the majority of the company's shares. They do not vote for the board of directors;

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instead, a trust votes the workers' shares. Managers, Inc.'s own directors appoint the committee that votes the trust's shares. Shockingly, those directors find themselves entrenched, winning repeated reelection under this system. The workers own the firm, but they have little or no say in the management of the firm.

Some of those who interact with Managers, Inc. restrain the company to a degree. Fat Cat the Banker is reluctant to lend to the firm if it seems too poorly managed, though Fat Cat has a hard time determining how good the managers of Managers, Inc. are. Widgets, Inc. sells competing products—if Managers, Inc. does too sloppy a job, it will go out of business. The Boss at Supercorp may be reluctant to hire managers from Managers, Inc., if he thinks they are not doing a good job, though like Fat Cat he has a hard time distinguishing good managers from bad ones. Senator Short, not quite getting it, wrote a law encouraging Managers, Inc. and Demoplace Corp., another employee owned corporation, indiscriminately. All these people do at best a mediocre job of keeping Managers, Inc. in check. Can the Judge—one of the most respected members of the community—come to the rescue?

On the other side of town, Demoplace Corp.'s workers own the majority of the company's shares. They vote for the board of directors, and help make practical, day-to-day decisions in their immediate workplace. Trust grows between managers and workers, and the directors and officers are re-elected, reflecting a job well done. Demoplace Corp. grows more efficient; its employees are more satisfied; the workers own and help manage the firm; and the world has become a slightly more democratic place.

Federal tax law encourages the development of Employee Stock Ownership Plans (ESOPs). Many have the inbred control structures of Managers, Inc., but some of them strive towards the participatory environment of Demoplace Corp. Can we constrain the former, while still encouraging the latter? That is the question this article poses. Section II sets out the factual background for this question. Several reported cases in federal court illustrate the problem

and some interesting legal issues. In those cases, plaintiffs have gone to federal court to try to stop managers who use ESOPs to entrench themselves, claiming the entrenchment violates fiduciary duties under the Employee Retirement and Income Security Act (ERISA). In two older district court cases[1] the plaintiffs had succeeded, but in a more recent Sixth Circuit case the plaintiff failed.[2]

In part, we face a pure doctrinal question—does fiduciary duty under ERISA forbid managerial efforts at entrenchment by those who run ESOPs? Section III addresses that question. I suggest one intermediate doctrinal position that is quite plausible, albeit not dictated by the statutory language. On that position, merely voting to reelect oneself as director in an uncontested election should not suffice to state a claim under ERISA fiduciary law. However, courts should apply an intermediate level of scrutiny to managerial decisions when managers who control ESOPs, such as those at Managers, Inc., vote for themselves in a contest for control of the company.

Can the Judge usefully help control Managers, Inc.? The problem of monitoring willful managers is not a new one, in the business world or in scholarship about the business world. At least since Berle and Means's classic book on modern corporations,[3] economists have worried about the split between ownership and control dividing shareholders from managers. Shareholders are the legal owners of corporations; they receive the residual income that is left after contractually-required payments are made and the corporation is supposed to be run in their interest. And yet managers who often own only a small fraction of a corporation actually run it. Shareholders vote for the board which appoints top managers, but most shareholders have too small a stake in any one corporation to pay much attention. When shareholders do little to monitor managers, manag-

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[1] *See* O'Neill v. Davis, 721 F. Supp. 1013 (N.D. Ill. 1989); Newton v. Van Otterloo, 756 F. Supp. 1121 (N.D. Ind. 1991).

[2] *See* Grindstaff v. Green, 133 F.3d 416 (6th Cir. 1998).

[3] *See* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1954).

ers can find many ingenious ways to make their lives more pleasant which do not vigorously advance the interests of the company's owners.

Some have suggested that a worker stake in businesses could reduce this problem, as worker-owners would have better information than ordinary shareholders about how their firm is run and more incentive to intervene if managerial problems arise.[4] ESOPs have for several decades been the most prominent way of promoting worker ownership within the United States[5] And yet, due in part to the way ESOP law is structured, ESOPs often worsen the ownership/control problem, leaving managers even more firmly entrenched than in ordinary corporations.[6] Most ESOPs look more like Managers, Inc. than like Demoplace Corp.

Can our Judge, brandishing ERISA fiduciary law to subdue the arrogant Managers, Inc., help control this managerial monitoring problem and make the world a better place? This question divides into two parts. First, what social goal do we hope the Judge's intervention will advance? That is the topic of Section IV. Standard corporate law scholarly analysis focuses on efficiency;[7] however, some of the most important arguments favoring worker ownership and control of firms concentrate on values such as justice, democracy, and self-realization.[8] William Simon has

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[4] *See, e.g.*, SAMUEL BOWLES AND HERBERT GINTIS, *The Democratic Firm: An Agency-theoretic Evaluation, in* MARKETS AND DEMOCRACY: PARTICIPATION, ACCOUNTABILITY AND EFFICIENCY 13, 27-31 (Samuel Bowles et al. eds., 1993); Joseph E. Stiglitz, *Credit Markets and the Control of Capital,* J. MONEY, CREDIT, & BANKING 1330 (1985).

[5] *See, e.g.*, JOSEPH R. BLASI & DOUGLAS L. KRUSE, THE NEW OWNERS: THE MASS EMERGENCE OF EMPLOYEE OWNERSHIP IN PUBLIC COMPANIES AND WHAT IT MEANS TO AMERICAN BUSINESS 23 (1991).

[6] *See* JOSEPH R. BLASI, EMPLOYEE OWNERSHIP: REVOLUTION OR RIPOFF? 12-57 (1988).

[7] *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991).

[8] *See, e.g.*, ROBERT A. DAHL, A PREFACE TO ECONOMIC DEMOCRACY (1985); CHARLES E. LINDBLOM, POLITICS AND MARKETS (1977); JON ELSTER, *Self-Realization in Work and Politics: The Marxist Conception of the Good Life, in* ALTERNATIVES TO CAPITALISM 127-58 (Jon Elster & Karl Ove Moene eds., 1989).

argued that corporate law should focus more on issues of power and politics, not just economics and contracts.[9] Still, even when pursuing goals other than efficiency, careful institutional analysis of suggested policies is vital to effectively pursue whichever goals matter to us. Even many who enthusiastically support worker ownership because of their concerns about justice and democracy have been skeptical about the value of ESOPs as a means of advancing those goals.[10] Indeed many ESOPs may do more to advance managerial control rather than worker control, so even if one advocates a goal of economic democracy, as I do in section IV, support for ESOPs does not automatically follow. Nor is it obvious what advocates of economic democracy should want courts to do when faced with plaintiffs like those in the cases before us.

That leads to the second part of the question as to whether an activist Judge can help us out: given the social goals we identify as important, what means are best able to advance those goals? Section V pursues that question. In that pursuit I advance a comparative institutional analysis.[11] It is not good enough to say courts are generally poor at monitoring managers—perhaps in the case of Managers, Inc. all the alternatives are worse.[12] Should courts actively discipline corporate management, or should they leave that to market forces, to congressional reform of the law, or to agency regulation? Managers, Inc. may not be well run, but will the Judge make it more efficient? Mangers, Inc. appears quite undemocratic, especially when compared to Demoplace Corp., but is the Judge's courthouse

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[9] *See* William H. Simon, *Contract Versus Politics in Corporation Doctrine, in* THE POLITICS OF LAW 511-38 (David Kairys ed., 3rd ed. 1998).

[10] *See, e.g.,* David Ellerman, *Workers' Cooperatives: The Question of Legal Structure, in* WORKER COOPERATIVES IN AMERICA 257, 262-67 (Robert Jackall & Henry M. Levin eds., 1984).

[11] *See* NEIL KOMESAR, IMPERFECT ALTERNATIVES (1994) (discussing comparative institutional analysis).

[12] Komesar emphasizes that different institutions may all be poor at advancing social goals in some circumstances. *See infra* note 186 and accompanying text.

such a good place to advance democracy? It turns out that none of the four institutions considered here (courts, markets, Congress, and agencies) are particularly well-suited to monitor ESOP managers, but which one is the least bad—or rather, what combination of the four institutions is the least bad?

I shall argue that the alternative I suggest in answer to the doctrinal question is also an answer to the policy question. Managers who vote for themselves in an uncontested election should receive the same judicial deference most managers receive. Where entrenched ESOP managers vote for themselves in a contested election, however, they should be forced to defend their decision-making more carefully. This is not exacting judicial scrutiny; it may not go as far as some court decisions, but I think that going any further would do more harm than good. I thus suggest only a small role for judicial scrutiny of entrenched managers using ESOPs; that scrutiny is unlikely to make a big difference. Instead, those who advocate greater workplace democracy should focus on working within the market to create more companies like Demoplace Corp., using existing ESOP law to the extent it helps.

I. THE ISSUE

A. Factual background

Congress began to encourage ESOPs in 1974.[13] It took some time, but by the eighties many firms used ESOPs.[14] Companies use ESOPs both as an employee benefit and as a form of corporate finance. A trust is established containing shares of a company's stock held for the benefit of some of the company's workers. A committee or a trustee (or both) is established to manage and vote the trust's shares. Frequently, managers of the company run those committees. Although the trust can—and in some circumstances

[13] *See* BLASI, *supra* note 6, at 18-19.

[14] *See* BLASI & KRUSE, *supra* note 5, at 11, 23.

must—vote according to directions from the employees for whose benefits the shares are held, many times the trust instead votes based on the judgment of those running the trust. Here a potential conflict of interest arises: company managers supposedly manage the trust for the benefit of the employees, yet when the ESOP's vote is potentially decisive, they often have a strong self-interest in how the trust votes.

The structure of the defendant company in *Grindstaff v. Green*[15] provides a good example. An ESOP Administrative Committee directs the ESOP Trustee how to vote the shares of North American Corporation (NAC) stock that the Trust held.[16] The ESOP Administrative Committee has three members. The five-member NAC Board of Directors chooses two; the United Textile Workers of America union recommends the other.[17] The members of the NAC Board, in turn, are chosen by a vote of NAC's shareholders[18]—and the ESOP Trust controls 85 percent of NAC's stock. The NAC Board chooses a majority of the ESOP Administrative Committee, and that Committee in turn controls the vote for a majority of the NAC Board members. One sees how entrenchment might occur. Since 1985, Charles Green, president of North American Rayon Corporation (NAR),[19] and Tony Butts, the vice-president, have been members of the NAR Board and the ESOP Trust Administrative Committee, and they have been members of the NAC Board since its creation in 1990.[20] Surprise, surprise.

What should happen when the employees of a company like NAR/NAC, or Managers, Inc., sue, claiming that in voting for themselves the company's managers have violated their fiduciary duty under ERISA? That is our ques-

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[15] 133 F.3d 416 (6th Cir. 1998).

[16] *See id.*

[17] At the time of the lawsuit that member was Karl Grindstaff, the plaintiff who lent his name to the case. *See id* at n. 3.

[18] One of the five NAC Board positions is nominated by employees. *See id.* at 419.

[19] NAC's main subsidiary.

[20] *See Grindstaff*, 133. F. 3d at 418.

tion for this paper. Next we turn to the general legal background of this issue.

B. Legal background

The tax code and ERISA largely constitute the federal law encouraging and regulating ESOPs.[21] Of particular interest is the portion of ERISA that defines fiduciary duties.

By regulating ESOPs through ERISA, Congress has chosen to treat them as a form of employee benefit. ERISA was created to ensure that those running employee benefit programs would handle them carefully and responsibly, so that retired workers would not find themselves deprived of retirement benefits they had counted on because the company's fund had gone under. One important part of ERISA imposes relatively strict fiduciary duties for those administering ERISA programs. The fiduciary duties are largely drawn from the common law of trusts, although they are somewhat modified.[22]

ESOPs are exempted from many of the normal ERISA rules, however. ESOP investments need not be as diversified as other ERISA programs must be;[23] prudent investment rules are relaxed; prohibited transaction rules are loosened.[24] And some general ERISA provisions are less appropriate when applied to ESOPs. Most importantly, ERISA fiduciaries may also be officers or agents of a party of interest.[25] Indeed, it is quite common for those directing

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[21] For summaries of the law governing ESOPs, *see* BLASI, supra note 6, ch. 2, *The ESOP's Moving Parts* 31-62 and *Appendix A, Federal Tax Questions for ESOPs* 253-56; Henry L. Blackiston III et al., *ESOPs: What They Are and How They Work*, 45 BUS. LAWYER 85 (1989).

[22] *See* Daniel Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105 (1988).

[23] *See* 29 U.S.C. § 1104 (a)(2) (1996).

[24] *See* 29 U.S.C.§§ 1107(b)(1), 1104(a)(2) (1996).

[25] *See* 29 U.S.C. § 1108(c)(3) (1996).

an ESOP trust to also be officers of the company.[26] The conflict of interest which this provision allows is more severe when the fiduciary controls the sponsoring company's own shares, as in an ESOP.

It is no great mystery why Congress exempted ESOPs from many of the main ERISA protections. By investing in the sponsoring company's own stock, ESOPs of necessity are in severe tension with one of ERISA's main objectives. ERISA aims to make investment in trusts for workers productive yet safe. Assuring that money will be available to pay promised benefits is a primary goal. Yet, ESOPs by their nature are too risky to fit well with this goal. An ESOP is not diversified—it invests in the stock of just one company. And that company is the very one in which the beneficiaries work, putting them at serious risk should that company run into trouble, since they would lose their job and their investment at the same time.[27]

Moreover, the kind of conservative decision-making expected of trust fiduciaries is in tension with the more risk-taking approach typical of a successful business concern. Courts have recognized this in the standard business judgment rule of corporate law.[28] Where an ESOP has a controlling interest in a company, binding its trustees to the more conservative approach could put the company at a serious disadvantage when up against less constrained competitors. Furthermore, Congress meant to promote ESOPs as a form of corporate finance,[29] and managers might be less likely to use ESOPs, as opposed to other forms of finance, were they forced to relinquish control of the funds to other fiduciary trustees.

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[26] *See Grindstaff*, 133 F.3d at 422 (citing Matthew M. O'Toole, *The Disproportionate Effects of an ESOP's Proportional Voting*, 24 NW. U. L. REV. 824, 826 (1991)).

[27] *See* Fischel & Langbein, *supra* note 22, at 1156; William R. Levin, *The False Promise of Worker Capitalism: Congress and the Leveraged Employee Stock Ownership Plan*, 95 YALE L.J. 148, 168 (1985).

[28] *See* Easterbrook & Fischel, *supra* note 7, at 99-100.

[29] *See* BLASI, *supra* note 6, at 22-23.

Still, ERISA does impose some fiduciary restraints on ESOPs. ESOP fiduciaries must discharge their duties "solely in the interest of the participants and beneficiaries."[30] Also, a fiduciary may not "deal with the assets of the plan in his own interest."[31] Our question in section III will be: how do these provisions apply to officers of companies controlled by ESOPs?

The other main source of federal law affecting ESOPs is the tax code. Various tax provisions provide incentives to form ESOPs.[32] Both the interest and the principal used to fund leveraged ESOPs are deductible.[33] Company contributions to an ESOP are deductible.[34] Lenders making loans to an ESOP may deduct 50 percent of the interest earned.[35] A variety of other, smaller inducements are sprinkled throughout the tax code. Though it is easy to exaggerate how much the code encourages ESOPs as opposed to other forms of employee benefit programs, it does give ESOPs somewhat favored status.

The tax code imposes some limitations on how ESOPs may be structured to receive these advantages. Of particular interest here is how the code treats voting rights of ESOP stock. One must distinguish between allocated and unallocated stock. Allocated stock is stock that has already vested in an individual employee. When an ESOP is created, a certain percentage of the company's stock is immediately put in the control of the ESOP. But at first no individual employee necessarily has a right to any of that stock. Employees gradually receive a vested right to a certain amount of stock, depending on how long they have been with the firm and according to the vesting schedule defined in the ESOP plan. At first, however, much of the stock may

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[30] 29 U.S.C. § 1104(a).

[31] 29 U.S.C. § 1106(b)(1) (1996).

[32] *See* BLASI, *supra* note 6, at 253-56; Blackiston *et. al.*, *supra* note 21, at 102-10.

[33] *See* I.R.C. § 404(a)(9). In a leveraged ESOP the ESOP Trust takes out a loan to pay for the shares it receives.

[34] *See* I.R.C. § 404(a)(3).

[35] *See* I.R.C. § 133.

not be vested (it is unallocated); over time, more stock becomes allocated.[36]

The tax code does not direct voting rights over unallocated stock.[37] For allocated stock, though, it requires "pass through" voting in certain circumstances. Once an employee has vested rights to some shares of stock, that employee must be able to direct how those shares vote under some circumstances. For publicly traded firms, allocated shares must have pass through voting for all votes.[38] But, for closely held corporations, pass through voting is required only for fundamental corporate changes, such as mergers.[39] There have been attempts to require pass through voting on all votes in closely held corporations, and to require proportional voting for unallocated shares, but those attempts have failed.[40] Ninety percent of all ESOPs that control more than four percent of a company are not in publicly traded companies. This group comprises 60% of all employees who own shares in ESOPs.[41] Additionally, in most of those non-public companies the ESOPs do not allow pass through voting. Thus, ESOPs without pass through voting are the norm.

II. THE CASES

Let us make the issue more concrete by considering what happened in the reported cases, starting with *Grindstaff*. In 1985, the North American Rayon Corporation (NAR) faced economic hardship. After some hard bargaining, the United Textile Workers of America (UTWA) agreed to wage concessions. In return, NAR remained in business

[36] *See* O'Toole, *supra* note 26, at 827-28.

[37] *See* Blackiston, *supra* note 21, at 95.

[38] *See* I.R.C. § 409(e)(2).

[39] *See* I.R.C. § 409(e)(3).

[40] *See* BLASI, *supra* note 6, at 161-63. Under proportional voting, unallocated shares are voted following the same proportion as the votes of allocated shares.

[41] *See* BLASI & KRUSE, *supra* note 5, at 11.

and set up an ESOP which controls 85 percent of NAR's stock.[42] An ESOP Trust holds the employees' stock for their benefit. In 1990 NAR formed a holding company called North American Corporation (NAC). NAC stock replaced the NAR stock as the stock held by the ESOP Trust.[43]

In 1991, employees and the union requested that the ESOP Trust institute "pass through voting." They filed a lawsuit attempting to force the ESOP to adopt that system. The lawsuit settled without the workers achieving pass through voting, though they did succeed in getting a worker representative added to the NAC Board, and in requiring that two of the other NAC Board members be outside directors.[44] In another shocker, these two outsiders turned out to be friends and associates of NAR's top managers.[45] Pass through voting was again an issue in the 1994 labor negotiations. The NAC Board refused to agree to a change in the by-laws, claiming its lenders would reject the proposal. In response, the UTWA launched a two-month strike. When that failed to make NAC back down, workers and the union sued in federal court.[46]

The suit named both individual directors, NAC, and NAR as corporate entities. It claimed that both the NAC Board's appointment of the ESOP Committee's members and the Committee's direction of the vote for the NAC Board, as well as the NAC Board's rejection of pass through voting, violated fiduciary duties mandated under ERISA.[47] The basic theory was that NAR's managers used their control of the ESOP Trust to entrench their own position in the

[42] *See* Grindstaff, 133 F.3d at 418, 426-27 (Krupansky, J., dissenting). Management controls the remaining 15 percent. *See id.* at 418.

[43] *See id.*

[44] *See id.* at 419 & n.5.

[45] *See id.* at 428 (Krupansky, J., dissenting).

[46] *See id.* at 419.

[47] *See id.* More precisely, in an uncontested election such as this one, the claim must be that the board members violated their fiduciary duty in nominating themselves, or perhaps in blocking the nomination of others. Once they are nominated, the ESOP could hardly vote for anyone else, especially where company bylaws limit write-in candidacies.

company, although approving pass through voting would have been in the better interest of the employee owners to whom they owed a duty of loyalty. The district court dismissed for failure to state a claim under Federal Rules of Civil Procedure 12(b)(6) and 12(c).[48] The Sixth Circuit affirmed by a 2-to-1 vote.[49]

The majority opinion in *Grindstaff* saw the decisive question as whether the ESOP stock voting rights were a "plan asset."[50] ERISA's prohibition on interested transactions says a fiduciary shall not "deal with the *assets* of the plan in his own interest."[51] The court phrases the issue in two somewhat different ways. At first the court says that "whether or not Plaintiffs have stated an ERISA claim in this case turns, as an initial matter, on whether 'stock *voting rights'* constitute an ERISA 'plan asset'."[52] However, the court goes on to add "[m]ore specifically, the issue is whether the right to vote ESOP shares in a regular annual election of the corporate board of directors for the purpose of electing plan fiduciaries to the corporate board constitutes a 'plan asset' within the meaning of ERISA."[53]

Throughout the opinion, it remains rather unclear exactly which of these two questions the court is answering. The answer to that determines how broad the holding is. Has the Sixth Circuit held there is no fiduciary duty whenever an ESOP trustee votes ESOP stock, or only more narrowly that voting in a regular, uncontested board election is not subject to such a duty?

The court begins its analysis by noting that Congress specifically allowed corporate managers to serve as ESOP fiduciaries, and that in practice this is the rule rather than the exception. The opinion also stresses that Congress in-

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48 *See id.* at 418; Grindstaff v. Green, 946 F.Supp. 540, 555 (E.D. Tenn. 1996).

49 *See id.* at 426.

50 *See* Grindstaff, 133 F.3d at 420.

51 29 U.S.C. § 1106(b) (emphasis added).

52 *Id.* (emphasis in original).

53 *Id.*

tended to promote the creation of ESOPs and remove obstacles that might limit their use.[54]

The court then moves on to discuss the two earlier district court cases, *O'Neill* and *Newton*. The *Grindstaff* majority followed the logic of the district court below, which described both *O'Neill* and *Newton* as involving "entrenchment plus,"[55] as they did not involve simple uncontested board elections. There were control disputes in those cases, but not in *Grindstaff*.[56] It is unclear whether the Sixth Circuit simply distinguishes the two prior cases on this ground, or disagrees with their analysis—it also says that the *O'Neill* and *Newton* courts "without any clear analysis, summarily treated the right to vote the ESOP shares as a plan asset."[57]

The court's language wobbles back and forth between the broader and the narrower holding. In its final statement of its position, the court says "we cannot say that the mere voting of an ESOP's stock by incumbent directors to perpetuate their own incumbency constitutes a breach of an ERISA fiduciary's duty in the handling of a 'plan asset.'"[58] This sounds like the broad version. But the next sentence continues, "[p]ut another way, the right to vote, or direct the voting of an ESOP's shares, even when used to perpetrate (sic)[59] one's own incumbency, does not, by itself, constitute a plan asset."[60] That, "by itself" suggests the possibility of the narrower "entrenchment plus" approach. In particular, the court may leave open the possibility that where a board election is *contested*, a fiduciary duty may apply.

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[54] *See id.* at 421-22.

[55] Grindstaff, 946 F.Supp. at 550.

[56] *See* Grindstaff, 133 F.3d at 424. This claim is factually dubious, at least vis-à-vis *Newton*, where there was no alternative slate in the board election.

[57] *Id.* at 422.

[58] *Id.* at 425.

[59] Note, their word choice is presumably a typograhpical error.

[60] *Id.*

In *O'Neill v. Davis*,[61] the former CEO of Lester B. Knight and Assoc., Inc. sued after he was removed from the board and fired by a 90 percent ESOP-owned company. Each member of the board of trustees was also a trustee of the Employee Stock Ownership Trust. The members of the board other than the CEO, acting as ESOP trustees, voted to reconstitute the board, and did not re-elect the CEO. The board then fired him. The former CEO claimed his fellow trustees violated their fiduciary duty under ERISA by voting to further their own interests.[62]

In analyzing this claim, the court focused on ERISA's definition of a fiduciary as one who "exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets."[63] The court emphasized that the statute refers to management or disposition of plan assets. It inferred that the fiduciary duty does not extend merely to investment decisions, but also covers the exercise of control over assets.[64] Exercise of control over the stocks owned as an asset includes choosing how to vote that stock. The court looked to principles of trust law, and found that the fiduciary duty there extends to voting on stock shares held in trust.[65] It held that the plaintiff had stated a claim under ERISA.[66] However, it is vague as to what it takes to state a claim on this theory. It appears to hold that so long as the complaint states that the ESOP trustees voted to further their own personal interests, that suffices to state a claim.[67] If so, the decision indeed conflicts with *Grindstaff*, and makes it easy to state a claim. Of course, it may not be easy to prove that claim—the court gives no hint as to what would constitute

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[61] 721 F.Supp. 1013 (N.D. Ill. 1989).

[62] This demonstrates that not only workers can brandish the fiduciary duty against ESOP trustees.

[63] 29 U.S.C. § 1002(21)(A)(i).

[64] *See* O'Neill, 721 F.Supp. at 1015.

[65] *See id.*

[66] *See id.* at 1016.

[67] *See id.* at 1015-16.

e court gives no hint as to what would constitute adequate proof of a breach of fiduciary duty.

In *Newton v. Van Otterloo*,[68] an ESOP held 81 percent of the stock in South Bend Lathe, Inc. In a proxy fight over re-election of the management-dominated board, the similarly management-dominated ESOP Committee decided not to solicit the votes of ESOP retirees. As a result, 70 percent of the ESOP's shares were not voted, and the votes of the incumbent management were enough to re-elect the board and to create a staggered board with three-year terms for directors. The court followed *O'Neill* in holding that a fiduciary duty applies in deciding how to vote ESOP stock.[69] It applied the Seventh Circuit's three prong test from *Leigh v. Engle*[70] for deciding whether a plan fiduciary has violated the duty of loyalty. Under that test, a court must ask:

> (1) whether the conflict of interests is so great that it is virtually impossible for the fiduciary to discharge the duties with an eye single to the beneficiaries' interests, and
> (2) if not, whether the fiduciary engaged in an intensive and independent investigation of options to ensure that the action taken was in the beneficiaries' best interests, and
> (3) the extent to which the use of the trust's assets tracked the best interest of another party.[71]

The *Newton* court held that the ESOP trustees did not violate the first prong, but they violated the second prong because they did not engage in an "intensive and scrupulous independent investigation of their options."[72] It would appear that the trustees must make this intensive investigation before any potentially self-interested decision, in-

68 756 F.Supp. 1121 (N.D. Ind. 1991).
69 *See id.* at 1128.
70 727 F.2d 113 (7th Cir. 1984).
71 Newton, 756 F.Supp. at 1127.
72 *Id.* at 1129.

cluding any decision to elect themselves to the board. The court granted summary judgment for the plaintiffs against the trustees, even though it saw much force in the argument that a vote against the management slate, with no alternative presented, would have caused corporate chaos.

Judge Krupansky dissented from the majority in *Grindstaff.* He thought that the complaint alleged enough to state a claim. Following the analysis in *O'Neill* and *Newton,* he argued that although ERISA fiduciary duties do generally focus on the investment of plan assets, they also apply to the management of such assets.[73] His analysis of "asset" is more detailed than that of the majority, commending the general approach of the Ninth Circuit in *Kayes v. Pacific Lumber Co.,*[74] which holds an item is an asset if it "may be used to the benefit (financial or otherwise) of the fiduciary at the expense of plan participants or beneficiaries."[75] He also pointed to the common law of trusts, where voting shares of stock are subject to fiduciary restrictions.[76]

Judge Krupansky also noted that the United States Department of Labor had filed an amicus brief arguing there should be a fiduciary duty limiting how a trustee may vote a plan's stock shares. The dissent argued this position is due deference under *Chevron v. Natural Resources Defense Council.*[77] The majority noted the Department's position but made no reference to *Chevron.*[78]

Finally, Judge Krupansky argued that if one understands the majority as recognizing there may be a duty in the "entrenchment plus" situation, then the majority reached the wrong result in this case. The complaint alleged that the defendants "used their voting power to perpetuate contractual and lease agreements between NAC, NAR, and other businesses the individual directors

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73 *See id.* at 431.

74 *See id.* at 432.

75 *Id.* (citing Kayes v. Pacific Lumber Co., 51 F.3d 1449, 1467 (9th Cir. 1995)).

76 *See id.*

77 *See id.* at 432-33.

78 *See id.* at 424.

owned."[79] Krupansky argued that this should count as the "plus." Again, the majority does not respond to this argument.

III. DOCTRINAL CONSIDERATIONS

This section III considers the correct interpretation of ERISA law as it stands using the standard tools of statutory interpretation. This section is a precursor to the paper's main object: a policy analysis of the issues raised. This paper addresses how well ESOPs function and how well they serve their purposes, whether the law governing ESOPs need to be reformed and whether the courts' resolutions of the issue help or hurt matters. Before proceeding to that analysis, though, I engage in a more traditional statutory analysis, looking at statutory language and structure, legislative history and purpose, fiduciary duty in the control transaction context, and the Department of Labor's position.

A. Statutory language and structure

The various provisions of ERISA interact in a not particularly clear way. What doctrinal analysis makes as much sense as possible of these provisions taken together as a whole, applied in circumstances where ESOP managers entrench themselves.

There are four main sections of interest. Section 1002(21) defines a "fiduciary."[80] Section 1104 sets the fiduciary standard of care.[81] Section 1106 defines prohibited transactions between plans and fiduciaries.[82] Section 1108 allows corporate managers to serve as fiduciaries.[83]

Section 1002(21) defines a person as a fiduciary "to the extent (i) he exercises any discretionary authority or discre-

[79] *Id.* at 433.
[80] *See* 29 U.S.C. § 1002(21).
[81] *See* 29 U.S.C. § 1104.
[82] *See* 29 U.S.C. § 1106.
[83] *See* 29 U.S.C. § 1108.

tionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets."[84] The *Grindstaff* court took as decisive whether the right to vote the ESOP's shares, under the circumstances of the case, was a plan asset and found that it was not

The court could have framed its inquiry differently. Rather than ask whether the right to vote the stock was an asset, it could have asked whether the stock itself was a plan asset. Since it surely was, the court would then have asked whether in voting for directors the trust was managing that asset. This is the more natural way of framing the inquiry. The *O'Neill* and *Newton* courts and Judge Krupansky's dissent in *Grindstaff* basically followed this more natural route by stressing the disjunctive "management or disposition" of plan assets.[85] Deciding how to vote one's shares is one part of managing those shares. *Grindstaff* is rather puzzling, looked at this way.

Note though that *Grindstaff*, unlike the other two cases, concerns two different sets of actions. One was the ESOP Trust's decision to vote its shares in favor of the incumbent board. The previous paragraph suggests that as the ESOP's shares are clearly a plan asset, and voting those shares is part of managing that asset, this action falls within the scope of the fiduciary duty. A second action was the NAC board opposing pass through voting. This was an ordinary business decision of the company's board. NAC itself is not a plan asset, so managing NAC does not fall within the fiduciary duty's scope. Thus, *Grindstaff* seems better justified with respect to the board's action, as opposed to the Trust's. The distinction is not purely academic either—some defendants were both NAC board members and ESOP Administrative Committee members, but others were just board members.[86] Under the interpretation just

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[84] 29 U.S.C. § 1002(21)(A)(i).

[85] *See Grindstaff*, 133 F.3d at 431 (Krupansky, J., dissenting); O'Neill, 721 F.Supp. at 1015; Newton, 756 F.Supp. at 1128.

[86] *See Grindstaff*, 133 F.3d at 418.

suggested, the defendants who only served on the NAC board should be free from liability.

Returning to the actions of ESOP trustees, section 1108 lends the strongest support to *Grindstaff's* interpretation of ERISA. Fiduciaries may also be officers or employees of the company.[87] Since the law contemplates this dual role, it is difficult to contend that directors violate the laws simply by telling the trust to vote for themselves? Even if one accepted this position, though, the law would perhaps be better stated by saying not that the right to vote the stock under such circumstances is not a plan asset, but rather that voting in one's favor does not, in itself, violate the fiduciary duty. This would avoid the apparent awkwardness of *Grindstaff's* position (on the narrower interpretation of its holding) that the right to vote the stock in an uncontested board election is not a plan asset, while perhaps the right to vote in a contested election is a plan asset.[88]

Moreover, it is questionable that voting the stock in an uncontested election while managing a plan asset will not violate a fiduciary duty. While section 1108 allows managers to direct an ESOP to vote for themselves, section 1104 still requires that the decision of how to vote must be "solely in the interest of the participants and beneficiaries."[89] While managers may vote for themselves, courts should subject such a decision to higher scrutiny because of the potential for self-interested voting. Such a standard of review would harmonize the various sections.

Perhaps the dispute here is—or should really be—about prima facie cases and the burden of production. We should interpret *Grindstaff* as holding that merely producing evidence of managers directing an ESOP to vote for themselves does not adequately state a claim of fiduciary duty violation. Plaintiffs must produce evidence of more than just managers voting for themselves, since section 1108(c) contemplates that. Although a fiduciary duty does still ap-

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[87] *See* 29 U.S.C. § 1108(c)(3).

[88] *See Grindstaff*, 133 F.3d at 422-23.

[89] 29 U.S.C. § 1104(a)(1).

ply to this decision, as to all decisions in managing a plan asset, the law requires more of a showing of conflict of interest in order to find a violation of that duty—"entrenchment plus."[90] What exactly that more might be is hard to discern from *Grindstaff*. Judge Krupansky's dissent suggests that the plaintiffs did plead entrenchment plus, but he is vague as to what they pleaded, and the majority does not engage the dissent on this point.[91] Egregious conflicts of interest would do the trick, but what lesser allegations might state a claim? One possibility is that officers directing a vote for themselves in a *contested* board election would be enough to shift the burden to defendants to show a thorough investigation or fairness to the company. *Grindstaff* leaves open this possibility, at least on the narrow interpretation of its holding.

Newton and *O'Neill* probably stand for an alternative position: showing an officer has directed an ESOP trust vote for himself presents a prima facie case of violation of the fiduciary duty. The defendant must then produce evidence showing there was no conflict of interests. This might be evidence of an independent investigation of the options, or that the managers did not track too closely their own self-interest as opposed to the trust beneficiaries' interest.[92] This position is consistent with section 1108—managers are not prohibited from being fiduciaries; however, they must show that they have not violated their fiduciary duty in voting for themselves.[93]

Defining the conflict around the burden of production helps clarify what is actually at stake between *Grindstaff* and *Newton*. Both positions appear consistent with ERISA's language and structure—indeed, there is not much

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[90] *See Grindstaff*, 133 F.3d at 422.

[91] *See id.* at 433 (Krupansky, J., dissenting).

[92] *See Newton*, 756 F.Supp. at 1128; Leigh, 727 F.2d at 127.

[93] Note that if simply producing evidence of better available directors can count as the "plus" of the "entrenchment plus" approach, then the two positions differ only in who they require to initially plead and produce evidence as to the relative qualifications of board candidates.

reason to prefer one over the other on these grounds. This approach also seems to shrink the difference between the two sides. Each finds that an ERISA fiduciary duty applies when ESOP trustees elect themselves to a company's board. Each nonetheless agrees that such a self-interested vote does not necessarily breach that duty, and that further evidence must be reviewed. They differ only on who has the burden of producing evidence once it is shown that trustees have voted for themselves.

Practically, though, the difference will be significant. If managers face the potential threat of having to affirmatively justify their decision every time they direct an ESOP to vote for themselves, that might deter them from doing so more often, or induce them to do more to cover themselves in case their decision is questioned. How big the difference is depends on how much more a plaintiff must show under the "entrenchment plus" approach to state a claim. If it is not much more, the two positions are not so different and plaintiffs would then usually be able to easily state a claim thereby putting the burden on trustees to justify their decisions.

B. Legislative purpose and history

Since the statutory language and structure are consistent with two rather different approaches, many (though not all) jurists would look to legislative purpose, history, and intent to provide guidance.[94] In this instance, as in most instances, I am aware of no evidence of legislative intent on the specific issue in question. There is, though, some relevant evidence from legislative history as to Congress's purpose in creating ESOP law.

Although ESOPs have been alleged to fulfill many purposes, chief among them is that of broadening ownership of capital within a capitalist system. Louis Kelso stressed this

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[94] *See* ANTONIN SCALIA, A MATTER OF INTERPRETATION: FEDERAL COURTS AND THE LAW 29-37 (1997) (arguing Justice Scalia would be skeptical).

goal in the initial work advocating ESOPs.[95] Kelso converted Senator Russell Long to the cause, and Long became the chief advocate of ESOPs in Congress.[96] Kelso continued both to lobby Congress and to develop ESOPs in practice through the investment bank he set up, Kelso and Company.[97]

Other benefits alleged for ESOPs include encouraging capital formation through an improved form of finance, improved management-labor relations, and increased productivity.[98] Increasing worker control in the workplace has apparently not been a major Congressional goal. Indeed, it would be surprising to find Congress pursuing a relatively radical change in the corporate power structure of this country through relatively little debated and obscure sections of the tax code and ERISA.

At several points, persons in the executive branch tried to change ESOP law to give participants more control over ESOP fiduciaries, fearing managerial entrenchment. In 1976 the Department of the Treasury and the Department of Labor issued proposed regulations calling for independent third-party trustees and voting rights in leveraged ESOPs.[99] Congress attacked the proposed regulations, saying,

> The Act reaffirms Congressional intent with respect to employee stock ownership plans and expresses concern that administrative rules and regulations may frustrate Congressional intent. In this connection it has come to the attention of the Congress that proposed regulations issued by both the Department of Treasury and the Department of Labor on July 30, 1976, may make it virtually impossible for ESOPs,

[95] *See* LOUIS KELSO, THE CAPITALIST MANIFESTO (1958).
[96] *See* BLASI, *supra* note 6, at 7.
[97] *See id.* at 22-23, 134.
[98] *See id.* at 18-28.
[99] *See id.* at 153.

> and especially leveraged ESOPs, to be established and to function effectively.[100]

The proposed regulations were withdrawn.

In 1985 the Treasury Department suggested, as part of the tax reform project, that workers must have all the rights of direct ownership, including the ability to elect directors, in order for the company to receive the tax benefits of ESOPs. Senator Long objected to the proposed changes as likely to discourage the creation of ESOPs. Congress did not make the changes.[101]

This history suggests that Congress has tried to promote widespread use of ESOPs. It has advocated worker ownership, but not worker control of the firms they partially or totally own. Measures which bolster worker rights over the ESOPs, but which might discourage managers from adopting such ESOPs, have not received support. Where the statutory language supports two plausible interpretations, the legislative history this appears to favor that position which burdens company management less. This, then, is an argument for the position that evidence of managers voting to entrench themselves on the board is not on its own sufficient to state a claim under ERISA's fiduciary duties. Indeed, the *Grindstaff* court points to some of this legislative history and purpose.[102]

C. Fiduciary duties in the control transaction context

Another area to look for guidance is the standard common law of fiduciary duty for corporate directors and officers. ERISA was enacted against a common law background, and in part codifies that law.[103] Of particular interest is the law in the context of hostile takeover attempts. The managers of takeover targets, like managers who con-

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[100] *See id.*

[101] *See id.* at 154-57.

[102] *See Grindstaff*, 133 F.3d at 421-22.

[103] *See O'Neill*, 721 F.Supp. at 1015; Firestone Tire and Rubber Co. v. Bruch, 489 U.S. 101, 110 (1989).

trol an ESOP Trust, occupy an intermediate ground. In both, there is reason to fear a conflict of interest, as managers have incentive to entrench their own positions, whether or not that is in the company's best interests. Yet, in both there is also reason to be cautious of courts becoming overly involved in second-guessing managerial decisions, as retaining incumbent managers may often be in the company's best interests and courts are not too good at telling when incumbent managers should or should not be encouraged to stay.

Subsection A above spoke vaguely of the "fiduciary duty" generally. Yet, legal commentators differentiate between the duty of care and the business judgment rule, on the one hand, and the duty of loyalty on the other.[104] In most circumstances, the weaker duty of care applies to corporate directors, along with the associated business judgment rule. So long as a board's decision was made in a good faith belief that it serves the company's best interests, and so long as the board was reasonably diligent in deliberating before acting, courts will not second-guess corporate actions.[105] However, where some of the directors have conflicting interests—e.g., where the corporation does business with another company owned by one of the directors—courts will apply stricter scrutiny under the duty of loyalty.[106] Where this duty applies, courts will not ratify a board's decision unless it is approved by a majority of informed, disinterested directors, approved by a majority of informed, disinterested shareholders, or is fair to the corporation.[107]

Even when there are no conflicting interests, courts may not give boards and officers a free pass. In the famous case of *Smith v. Van Gorkom*,[108] the Delaware Supreme Court announced that if directors do not carefully inspect the details of an acquisition, they may be held liable. To get the

[104] *See* DENNIS J. BLOCK ET. AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS (5th ed. 1998).

[105] *See id.* at 5.

[106] *See id.* at 262.

[107] *See id.*

[108] 488 A.2d 858 (Del. 1985).

benefit of the business judgment rule, a board's judgment must be informed. Though *Van Gorkom* caused quite a commotion, its impact has been limited. Many states, including Delaware, passed laws allowing companies to limit director and officer liability, and many companies took advantage of those laws.[109] Few cases since have found director liability based on a failure to become informed.[110] Still, the decision may have induced boards to take prophylactic measures to avoid liability.

Most of the time the business judgment rule is appropriate. However, sometimes out-and-out conflicts of interest require duty of loyalty analysis; managers faced with a hostile takeover threat fall in-between. The interest of incumbent managers in retaining control may conflict with the best interest of the corporation, but then again, rejecting the suitor may be in the corporation's long-term interest.[111] Frequently there will be good arguments on both sides. What is a court to do? What Delaware courts, which have created most of the case law in this area, have done is create a juiced-up version of the business judgment rule. The key case, *Unocal Corp. v. Mesa Petroleum Corp.*,[112] created a two-pronged test for evaluating defensive actions taken to combat a hostile takeover. First, directors "must show they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed."[113] Second, the defensive mechanism "must be reasonable in relationship to the threat posed."[114] As formulated in later cases, particularly *Unitrin, Inc. v. American Gen. Corp,.*[115] defensive mechanisms will fail this second prong only if they are quite disproportional indeed. "[T]he law affords boards of directors substantial latitude in defending the perimeters of the

[109] *See* BLOCK, *supra* note 104, at 226-41.

[110] *See id.* at 167.

[111] Note that the same can be said for managers of ESOP-controlled companies.

[112] 493 A.2d 946 (Del. 1985).

[113] *Id.*

[114] See *id.*

[115] 651 A.2d 1361 (Del. 1995).

corporate bastion against perceived threats."[116] This case, to some extent like *Van Gorkom*, imposes something more than the normal, easygoing business judgment rule, but less than the strict duty of loyalty, in situations where there is concern about the incentives that directors face. As with *Van Gorkom*, defendants generally win under *Unocal*, and a wide variety of effective anti-takeover mechanisms have proliferated. Nonetheless, the case has probably forced boards to take some measures to assure their decisions are informed and defensible, and the most extreme anti-takeover mechanisms have been struck down.[117] This, then, is a model of limited judicial involvement, but not total abdication.

The logic of *Unocal* can be extended to ESOPs. Indeed, it has been in cases where boards impose ESOPs in response to a takeover threat.[118] Beyond that, though, courts could find a duty of heightened inquiry in some instances where an ESOP is already in place. For instance, where there is a contested board race, perhaps incumbent directors and officers should have to show diligent investigation and a reasonable relationship between their vote and the interests of beneficiaries before courts approve voting for themselves. Does an uncontested board election create a similar need for heightened scrutiny? The Delaware takeover case law analogy suggests that in deciding where to draw the line in invoking somewhat heightened scrutiny, and in shaping what that scrutiny will look like, we must balance the risks of managerial conflicts of interest and limited judicial competence.

D. The Department of Labor and *Chevron*

In *Grindstaff*, the Department of Labor filed an amicus brief urging the Sixth Circuit to hold that voting rights are

[116] *Id.* at 1388 n. 38.

[117] *See* Mentor Graphics Corp. v. Quickturn Design Systems, Inc., (Del. Ch. Dec. 2, 1998)

[118] *See* Eric Grannis, *Note, A Problem of Mixed Motive: Applying Unocal to Defensive ESOPs*, 92 COLUM. L. REV. 851 (1992).

a plan asset. The *Grindstaff* majority simply replied "[w]e decline this invitation to so broad a declaration."[119] Judge Krupansky's dissent suggests, though, that the Department's position is due deference under *Chevron v. Natural Resources Defense Council*.[120] Under that case, on a matter of statutory interpretation the court should first look to whether the statutory language unambiguously settles the issue. If it does, that is an end to it. If not, and if the executive agency in charge of administering the statute has offered an interpretation, the court should then examine the agency's position. If that interpretation is reasonable, the court should defer to it.[121]

We have seen that ERISA's language fairly counts as ambiguous, at least as between the two positions described in subsection III.A above, namely entrenchment-plus versus simple entrenchment as triggering a shift to the defendant of the burden of production. The Sixth Circuit should thus have proceeded to *Chevron*'s second step.[122] Several questions arise here. First, is the Department of Labor entrusted with administering ERISA? Apparently, yes. In ERISA Congress authorized the Secretary of Labor to "prescribe such regulations as he finds necessary or appropriate to carry out the provisions of this subchapter."[123] Several circuits have held that the Department of Labor's interpretations of ERISA are due *Chevron* deference.[124] I am unaware of any court that has held otherwise.

Second, has the Department taken its position in a form that is due deference? Not all agency pronouncements are due deference under *Chevron*. For instance, where an

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[119] *Id.* at 424.

[120] 467 U.S. 837 (1984).

[121] *See id.*

[122] The *O'Neill* court also received a Department of Labor brief. Though without discussing *Chevron*, the *O'Neill* court followed the Department's reasoning. *See* 721 F.Supp. at 1015.

[123] 29 U.S.C. § 1135.

[124] *See* Herman v. NationsBank Trust Co. (Georgia), 126 F.3d 1354, 1363 (11th Cir. 1997); Matinchek v. John Alden Life Ins. Co., 93 F.3d 96, 100 (3d Cir. 1996); Bartling v. Fruehauf Corp., 29 F.3d 1062, 1072 (6th Cir. 1994).

agency is a party and has first adopted its position as a litigating stance in that case, that position is due no special deference.[125] Here, the court received an amicus brief. There is some ground for arguing that an amicus brief should receive an intermediate amount of deference. At one end of the spectrum are agency rules reached through notice-and-comment rulemaking, and interpretations reached as part of formal adjudication. Such decisions are clearly due full *Chevron* deference, as in such contexts agencies have formally deliberated and made policy choices pursuant to Congressionally mandated procedures.[126] At the other end are agency positions taken only as defensive positions in litigation, which are often post-hoc rationalizations adopted by lawyers to defend their clients.[127] An amicus brief falls in-between—it is not adopted following a formal proceeding, yet it is not taken in response to defensive litigation pressure either. A leading administrative law treatise suggests giving no deference to a position adopted in an amicus brief.[128] Yet the Supreme Court did recently give deference to a position from an amicus brief.[129] But it did so stressing that on the facts in that case, "[t]here is simply no reason to suspect that the interpretation does not reflect the agency's fair and considered judgment on the matter in question."[130] Several courts have deferred to Department of Labor positions on ERISA taken in opinion letters.[131] The Sixth Circuit has expressed a sliding scale standard of deference, saying "[t]he degree of deference to be accorded an agency's interpretation of a statute of Congress has charged it with administering varies, depending on several factors,

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[125] *See* Bowen v. Georgetown University Hospital, 488 U.S. 204, 212 (1988).

[126] *See* KENNETH CULP DAVIS & RICHARD J. PIERCE, JR., ADMINISTRATIVE LAW TREATISE § 3.5.

[127] *See* Bowen, 488 U.S. at 212; CULP & PIERCE *supra* note 126, at § 3.5.

[128] *See* CULP & PIERCE, *supra* note 126, at § 3.5.

[129] *See* Auer v. Robbins, 519 U.S. 452 (1997).

[130] *Id.*

[131] *See Herman*, 126 F.3d at 1363; *Bartling*, 29 F.3d at 1072.

including the existence of a statute mandating a standard of review, the form and formality of the interpretation, and the consistency of the agency's interpretation over time."[132] In this case, the Department of Labor has taken the same position in at least two cases over nine years. How well reasoned its positions are we cannot say, without the briefs in front of us.

Finally, even if the Department's position is due deference, has it necessarily answered the question before us? *Grindstaff's* holding does seem to conflict with the Department's position. But, we saw in subsection III.A that the majority's position can, and probably should, be re-cast as stating that although a fiduciary duty does apply to the act of casting ESOP shares' votes, merely presenting evidence of voting in favor of oneself as a director does not adequately state a claim of conflicting interest. Is the Department's position necessarily inconsistent with this version of *Grindstaff's* holding? Without the briefs, it is hard to answer that question.

E. Doctrinal wrap-up

The standard tools of statutory interpretation do not yield a clear answer here. The statutory language and structure do not provide any clear way of distinguishing between at least two possible positions. Legislative purpose and history suggest a restricted reading of the fiduciary duty. Deference to the agency that administers ERISA suggests a more aggressive fiduciary duty in the case that went *against* the Department of Labor's position, while not in one of the cases that supported the Department's position.[133] The common law of fiduciary duty in the takeover context suggests an intermediate level of scrutiny. Perhaps the argument so far slightly favors the following position: although a fiduciary duty applies to all decisions in voting ESOP stock, merely voting to elect oneself in an

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[132] Wolpaw v. C.I.R., 47 F.3d 787, 790 (6th Cir. 1995).

[133] There is no sign in *Newton* that the Department filed an amicus brief.

uncontested election is not enough to state an ERISA claim. Plaintiffs must show something more. Perhaps showing that the election was contested would be enough to state a claim. Once the plaintiff has stated a claim, the burden should shift to defendants to show that they engaged in an independent investigation and that their decision did not track too closely their own self-interest while diverging from the interest of the employee-stockholders.[134] This position follows *Grindstaff* in demanding entrenchment plus to trigger a burden shift, but then borrows from *Newton* and *Leigh* as to what managers must show once that burden shifts. Still, while a plausible position, the statutory language far from compels it. For those so inclined to consider policy arguments in close questions, we face a good candidate for doing so.

IV. THE PURPOSES AND EFFECTS OF ESOPS

The next section engages in a comparative institutional analysis of how well market forces, courts, administrative agencies, and Congress are likely in constrain ESOPs to accomplish what we want them to accomplish, and whether imposing a fiduciary duty is likely to help. First, we must consider what it is that we want ESOPs to accomplish, and how close they have come to accomplishing it.

A. Sharing the wealth

Wealth in the United States is highly concentrated. Many people believe this is unjust both in its own right, and because it increases political inequality. One of Kelso's major goals in promoting ESOPs was increasing the equality of wealth by promoting worker ownership of companies.[135]

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[134] *See* the second and third prongs of *Leigh*, 727 F.2d at 1127.

[135] *See* BLASI, *supra* note 6, at 18-22.

But using ESOPs to achieve this goal has a huge, oft-analyzed drawback. If more widespread ownership of wealth is the goal, why should it be ownership of stock in the same companies that employ the workers? Ownership of a broad, diversified portfolio would advance the same goal. It would also come at a significantly lower cost. Less wealthy employees are likely to be more risk averse than the more wealthy, and they already have a big stake in the financial health of the firm where they work. Yet an ESOP makes their financial well being even more dependent on that company, forcing them to bear more risk than if they owned a diversified portfolio.[136]

Simply sharing the wealth does not provide much of an argument for ESOPs as opposed to other ways of increasing workers' wealth. Nonetheless, wealth sharing seems to have been the most important motive of those influential in establishing ESOPs, especially Kelso and Senator Long.[137]

B. Capital formation and corporate finance

ESOPs have also been promoted as an alternative form of corporate finance that can encourage new capital formation.[138] Indeed, by lowering the costs of obtaining capital, ESOPs can encourage companies to invest more. This is not necessarily so, however. Issuing new stock to workers dilutes outstanding shares, unless the issue is financed either by employee concessions in wages, other forms of compensation, or by increased productivity and earnings.[139]

Moreover, one must still argue why we should encourage capital formation through this form of finance, rather than others.[140] The answer is parasitic on other alleged gains from ESOPs. The capital formation argument provides no

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[136] *See* Fischel & Langbein, *supra* note 22, at 1156; Levin, *supra* note 27, at 168; Richard L. Doernberg & Jonathan R. Macey, *ESOPs and Economic Distortions*, 23 HARVARD J. ON LEGIS. 103, 133-36 (1986).

[137] *See* KELSO, *supra* note 95; BLASI, *supra* note 6, at 18-22.

[138] *See* BLASI, *supra* note 6, at 22-23.

[139] *See id.* at 65-72.

[140] *See* Doernberg & Macey, *supra* note 136, at 104-05.

independent reason to encourage ESOPs as opposed to other forms of corporate finance. Indeed, by biasing the tax system in favor of ESOPs, Congress may well have induced some firms to choose them where other forms of financing would have been more efficient.[141]

C. Increased efficiency and productivity

Many claim that ESOPs increase productivity. In comparing the efficiency and productivity of employee-controlled companies with more standard investor-controlled companies, one must consider a variety of effects. First, differences in ownership may change the objectives we can expect companies to pursue. Second, different ownership and control structures may affect the incentives and motivation of individual employees. Third, employee ownership and control may affect what information companies are able to use in making decisions.

Economists generally conceive of standard investor-owned companies as maximizing the discounted present value of their expected flow of profit. A company fully owned by and run for the benefit of its employees would instead maximize the discounted present value of the flow of expected returns to its employees. The theoretical economic literature has been concerned with incentives for worker-owned firms to make inefficient production and hiring decisions.[142] They argue that because worker-owned companies would maximize average net return rather than marginal net return, they will not hire workers whom it would be efficient to hire when the revenue those workers would generate would outweigh the cost of hiring them[143] because such workers would bring down average profits.[144]

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[141] *See id.*

[142] *See* John P. Bonin et. al., *Theoretical and Empirical Studies of Producers Cooperative: Will Ever the Twain Meet*, 31 J. ECON. LIT. 1290, 1297-1302 (1993). *See also* Alan Hyde, *In Defense of Employee Ownership*, 67 CHI.-KENT L. REV. 159 (1991).

[143] In other words, the marginal profit from hiring them is positive.

[144] The seminal article is Benjamin Ward, *The Firm in Illyria: Market Socialism*, 48 AMER. ECON. REV. 566 (1958).

Essentially, the incumbent workers must share a part of their profit with the new one, so they choose not to hire him. It is an interesting theoretical point, but more sophisticated models vitiate it, and the point does not seem borne out empirically.[145]

Economists have also been concerned with possible incentives to under-invest.[146] They argue that worker-owned companies will have a shortened time horizon, as some workers will leave before all the gains from an investment are realized, and hence do not care enough about those future gains. By contrast, owners who leave capitalist firms get paid the expected future value of the company's profits, and hence have reason to care about that future value.[147] Again, more sophisticated theoretical models and empirical evidence suggest the problem has been overblown, as most employees can expect to be with the company long enough to capture most of the benefit from investments. An employee's stake in a company can be structured to improve the incentive, as they are, for instance, in the producer cooperatives of Mondragon in Spain.[148]

More seriously, Henry Hansmann makes some strong arguments why worker-owned firms often have high decision-making costs. The heterogeneity in most companies of workers' interests as opposed to the homogeneity of shareholders' interests may make decision-making in employee-run companies much more complicated and costly.[149] This remains an open question. I suspect that Hansmann overestimates the problem. Decision-making is a problem, but

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[145] *See* Bonin et. al., *supra* note 142, at 1298-1302.

[146] *See* Bonin et. al., *supra* note 142, at 1307-12; Hyde, *supra* note 142, at 15.

[147] *See* Erik G. Furobotn, *The Long-Run Analysis of the Labor-Managed Firm: An Alternative Interpretation*, 66 AMER. ECON. REV. 104 (1976).

[148] *See* HENK THOMAS & CHRIS LOGAN, MONDRAGON: AN ECONOMIC ANALYSIS 149-58 (1982).

[149] *See* Henry Hansmann, *When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination and Economic Democracy*, 99 YALE L.J. 1749 (1990); HANSMANN, THE OWNERSHIP OF ENTERPRISE 89-114 (1996).

companies can structure employee involvement to limit problems.[150] They can use representative government and limit worker input on decisions where workers are likely to fight over distributive shares rather than work together to increase productivity. Indeed, the widely discussed Mondragon cooperatives do so.[151] With more experience in employee involvement, companies would learn how to reduce the cost of involvement while getting the most benefit possible.

On the positive side, employees running a company would presumably not merely maximize expected financial return. They would care about other factors as well, e.g., workplace safety and creation of a satisfying work environment. Many argue that in the present system such factors are efficiently set by contract and by the labor market. There is something to that, but it is possible that market mechanisms do not reflect employee preferences with much accuracy. Workplace-wide issues may have a semi-public good quality that can prevent them from being efficiently priced. Putting it in term of "exit" versus "voice," for many employees in many circumstances it may be quite costly to exit a company because they dislike that company's policy on a particular issue. In such circumstances the threat of exit alone may not exert much pressure to follow a policy which reflects the desires of workers. When that occurs, allowing employees a voice in making policies may lead to an outcome that better reflects the preferences of all.[152]

Employee ownership may also affect individual employee incentives and motivation. Some argue that employees who own a share of their firm will feel they have more

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[150] *See* HANSMANN, *supra* note 149, at 98-103 (recognizing the structuring of employee involvement to some extent and discussing the Mondragon cooperatives).

[151] *See* WILLIAM F. WHYTE & KATHLEEN K. WHYTE, MAKING MONDRAGON: THE GROWTH AND DYNAMICS OF THE WORKER COOPERATIVE COMPLEX 295-96 (2d ed. 1991).

[152] *See* ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 36-43 (1970).

to gain from the company's success. Hence they will work harder and better.[153] This argument has some problems. In all but the smallest companies there is a free rider problem—what worker owners should want is for everyone else to work harder while they reap the benefits. This is especially true where the gains from working better depend on many people doing better, with the added input of just one person being small or nonexistent. Even where the increased output from one employee's input exists and is measurable, the worker has highly imperfect incentives because that increased output is divided among all the other owners. A worker bears all the cost of her increased effort, but gains only a fraction of the benefit. The incentive to work harder thus becomes dimmer and dimmer as the company becomes larger.[154]

There's a better chance of increasing productivity if ownership is combined with greater employee control or involvement in decision-making.[155] Such involvement is more likely to produce greater attachment to the company. It also may encourage employee monitoring of other employees, which can help overcome the incentive problems of widespread ownership.[156]

Another claimed source of improved productivity and efficiency from employee ownership comes from the potential for tapping into the huge store of ideas for improvements that employees build up on the job. Greater employee involvement may allow companies to make use of these ideas.[157] Employees, with their direct knowledge of what is going on at work, may be better able to monitor managers

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[153] *See* BLASI, *supra* note 6, at 25-27.

[154] *See* Martin L. Weitzman & Douglas L. Kruse, *Profit Sharing and Productivity*, *in* PAYING FOR PRODUCTIVITY 94, 98-100 (Alan S. Blinder ed., 1990).

[155] *See* Michael A. Conte & Jan Svejnar, *The Performance Effects of Employee Ownership Plans*, *in* PAYING FOR PRODUCTIVITY 143, 167 (Alan S. Blinder ed., 1990); BLASI, *supra* note 6, at 218-19.

[156] *See* Weitzman & Kruse, *supra* note154, at 99; Stephen M. Bainbridge, *Participatory Managmenet Within a Theory of the Firm*, 21 J. CORP L. 657, 690-696 (1996).

[157] *See* Bainbridge, *supra* note 136, at 680-90.

than distant, uninvolved shareholders. Employees also have better incentive to see that managers do a good job than do most shareholders. These information-based ideas are the strongest efficiency arguments in favor of employee ownership and control.

The empirical literature on ESOPs and worker ownership suggests that ownership alone does little to improve productivity. While some studies do find improvement, others do not, and the latter are analytically sounder than the former.[158] Overall, employee ownership alone at most increases productivity only a small amount, and even that small increase is hard to demonstrate. However, employee ownership combined with efforts to encourage greater employee participation in decision-making does seem to increase productivity significantly.[159] Ownership and participation seem to interact, producing more of a gain than either one tried separately. The most useful form of participation may well be day-to-day involvement in decisions in the immediate workplace, rather than occasional voting for the company-wide board of directors.[160] Such day-to-day involvement does more to use valuable employee information than does voting for directors. Such shop-level democracy may also have a stronger effect on employee motivation.

The legal structure of ESOPs allows greater employee participation, but does little to encourage it. As our legal issue demonstrates, current ESOP law does not necessarily encourage even democracy at the board level. Worse, ESOP law does nothing to encourage democracy at the shop or office level. Most ESOPs so far have done little or nothing to increase worker participation.[161] Thus, if greater productivity and efficiency are the goals that support ESOPs, the

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[158] *See* Conte & Svejnar, *supra* note 155, at 167.

[159] *See id.*

[160] Thus, the union in *Grindstaff* not only may have been mistaken in going to court, but also, perhaps, it should have focused on other forms of employee participation.

[161] *See* BLASI, *supra* note 6, at 241; BLASI & KRUSE, *supra* note 5, at 216; Levin, *supra* note 27, at 250.

law seems in need of an overhaul. We should only encourage with tax breaks those ESOPs that involve some degree of employee control. That does not necessarily mean that courts should be involved in enforcing a fiduciary duty in cases where employees lack that control.

Thus, there are some theoretical and empirical arguments for potential efficiency gains from employee ownership and control, though plenty of arguments on the other side as well. Even if worker participation can boost efficiency, it seems that ESOP law is not well structured to do so. But, there's another question facing those who want to use the law to encourage employee ownership and control on efficiency grounds. One must argue further why the government should subsidize democratic ESOPs or other forms of employee participation. If they work, companies should adopt them without subsidy. Those companies that do will out-compete those that do not.

That is a standard argument against subsidies,[162] but I think it goes too far in presuming the efficiency and evolutionary efficacy of markets. Various factors may inhibit companies from adopting greater worker participation, even if such participation would be highly efficient once widely adopted. First, managers have their own self-interested stake in limiting worker participation. The mechanisms constraining managers may be too weak to induce them to take action that undercuts their personal authority. Second, the efficacy of worker participation may be highly uncertain and require much learning about how to do it right. This could create what economists somewhat obscurely call increasing returns: high participation could succeed once many have tried it, thereby reducing the uncertainty, but early adopters have weak incentive to try.[163] This dynamic

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[162] *See, e.g.*, Levin, *supra* note 27; Fischel & Langbein, *supra* note 22; Doernberg & Macey, *supra* note 136; Michael C. Jensen & William H. Meckling, *Rights and Production Functions: An Application to Labor-Managed Firms and Codetermination*, 52 J. BUS. 469 (1979); Stephen M. Bainbridge, *supra* note 157 at 702-04 (1996).

[163] *See* Kenneth J. Arrow, *The Economic Implications of Learning by Doing*, 29 REV. ECON. STUD. 155 (1962); David Fudenberg & Jean Tirole,

may also show up in the funding of worker-participatory companies. Financial markets may find companies with participation a risky unknown which, in turn, may lead to a higher cost of capital for worker-participatory companies. The resulting lack of worker-participatory companies reinforces their risk in the eyes of financiers, so they do not finance worker-participatory firms (or charge a higher interest rate), reinforcing in turn the lack of worker-participatory firms, and so on in a vicious circle.[164] Another obstacle is that corporate law precedents may not be well developed to handle problems unique to worker decision-making, as courts encounter few such companies. The greater legal uncertainty surrounding such companies imposes another cost on them, again reinforcing their paucity in the economy.[165] The educational system may not do well in instilling the skills required to engage in participatory decision-making.[166] The broader society may not have created the kind of culture that encourages and aids worker involvement.[167]

Learning by Doing and Market Performance, BELL J. ECON. 522 (1983); W. Brian Arthur, *Self-Reinforcing Mechanisms in Economics, in* THE ECONOMY AS AN EVOLVING COMPLEX SYSTEM 9 (Philip W. Anderson *et. al.* eds., 1988).

[164] *See* Brett H. McDonnell, *Credit Markets, Learning, and Choice of Alternatives, in* LABOR MANAGED FIRMS AND BANKS, Ph.D. dissertation, Stanford University (1994). Of course, the higher interest rates for participatory companies may just reflect real operational risk inherent in such companies, rather than unfamiliarity, emphasizing the general difficulty discussed in the next paragraph of empirically determining the practical importance of theories predicting increasing returns and lock-in.

[165] On how the development of corporate law may exhibit lock-in, *see* Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts,* 81 VA. L. REV. 757 (1995); Klausner & Marcel Kahan, *Standardization and Innovation in Corporate Contracts (Or, the Economics of Boilerplate),* 83 VA. L. REV. 713 (1997); *but see* Mark A. Lemley and David McGowan, *Legal Implications of Network Effects,* 86 CAL. L. REV. 479, 562-86 (1988).

[166] *See* William H. Simon, *Comment,* 43 U. TORONTO L.J. 627 (1993).

[167] *See id.*

These and other factors may interact to make it quite difficult to move from one institutional equilibrium to another. It is by now well understood that such self-reinforcing mechanisms may lead economies to inefficient outcomes, with little or no tendency to move toward a more efficient outcome. The empirical importance of such mechanisms is hotly debated. There has been much less compelling empirical evidence (as opposed to theoretical demonstrations) of widespread lock-in to inefficient results. The issues are complex: the argument is often that an alternative organization form *could* be more efficient if it were to become more widely adopted than the current standard. How is one to distinguish such a situation from one where the current standard dominates because it is simply the most efficient? The counterfactual of how well an economy dominated by employee-controlled companies would function is very hard to determine.[168] Nonetheless, the kind of arguments briefly presented here suggest that the simple argument against subsidy is not so certain as it might appear. Companies with more employee participation might increase efficiency, yet market mechanisms might not lead to more such companies. Even so, one would still have to show that legal and political institutions would lead to increased efficiency where markets have allegedly failed. Section V will address this issue.

D. Industrial and political democracy

ESOPs might be valued as a direct increase in industrial democracy and an indirect boost to political democracy. Even though this was not a goal of Congress, and hence may well be an inappropriate goal for courts to pursue in

[168] For skepticism on the argument that network externalities are empirically important in the area of corporate law, *see* Lemley and McGowan, *supra* note 165, at 562-86.

interpreting federal laws,[169] it may be a goal that we as analysts and advocates want social institutions to advance.

Industrial democracy envisions greater involvement of workers in controlling their day-to-day working life. This can have efficiency justifications, which I have already briefly considered. It may also increase the psychological fulfillment of workers and reduce alienation.[170] Some also value industrial democracy in and of itself.[171] Just as having a say in how you are governed politically is a key value to many of us, so may be having a say in how you are governed in your working life, which after all is central to the lives of most adults. Industrial democracy may also improve political democracy. It may help people become more skilled in democratic decision-making and create a culture which values democratic participation more.[172] Some also argue that increased equality of wealth from worker ownership may reduce the pernicious effects that wealth inequality has on political democracy.[173]

What sort of workplaces would work best to advance this set of concerns? Is direct, active involvement by many employees in decision-making crucial, or can the less intense involvement of representative democratic decision-making advance such values? Values such as psychological fulfillment, reduced alienation, and self-realization would seem better advanced by more active involvement. Still, insofar as employees believed their elected representatives fairly represented them, more indirect forms of democracy can advance such values as well. Moreover, the gain to indi-

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[169] Unless one takes a highly dynamic approach to statutory interpretation. *See* WILLIAM N. ESKRIDGE JR., DYNAMIC STATUTORY INTERPRETATION (1994).

[170] For an argument along related lines promoting the value of self-realization, *see* Elster, *supra* note 8.

[171] *See, e.g.*, Dahl, *supra* note 8, at 111-35.

[172] *See* CAROL PATEMAN, PARTICIPATION AND DEMOCRATIC THEORY (1970); SAMUEL BOWLES & HERBERT GINTIS, DEMOCRACY AND CAPITALISM 131-35 (1986).

[173] *See* BOWLES, *supra* note 172, at 101-07; *but see supra*, section IV.A (arguing that ESOPs are a dubious means of decreasing wealth inequality).

viduals from greater participation in decision-making may be an inverted U-shaped: too little involvement is alienating, but too much involvement is exhausting. An intermediate level of participation may be optimal.

As for the intrinsic value of having a say in how one's workplace is governed, Robert Dahl has argued for a mostly representative version of democracy in all but the small company based on the intrinsic right to self-government. He argues that most employees are roughly equal in their ability to decide what sorts of decisions should be made collectively, and what decisions should be delegated to representatives.[174] The optimal mix of direct and representative democracy may well vary based on factors such as the size of the company, the complexity of its operations, the heterogeneity of the managerial abilities of employees, and so on.

As for industrial democracy as a training ground for political democracy, again it is unclear whether direct or representative democracy is more appropriate. Direct democracy more actively involves employees, giving them more of a chance to develop the skills of decision-making. But, representative democracy more closely resembles the sort of decision-making that occurs in our political institutions.

Are ESOPs well designed to meet these goals? Insofar as direct, rather than representative, democracy is more appropriate, the answer is no. ESOPs at least have a better shot at being valuable if we see representative democracy as better in tune with the goals of industrial democracy. Even here, though, ESOPs may well not be superior to other ways of involving employees in ownership and control, such as the widespread use of employee stock options or stock purchase programs. Indeed, the sort of in-bred structure which ESOP committees often lead to—this paper's subject—would seem far worse than other ways of giving employees an ownership stake. Still, one could envision an alternative version of ESOP law that encouraged programs in which employees became actively involved in

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[174] *See* Dahl, *supra* note 8, at 116-20.

decision-making. Simply giving employees shares with a vote does not mean they will become actively involved in voting. Various institutions could encourage more active participation. One possible traditional institution, which might fulfill similar functions, is unions. Indeed, unions involved in ESOPs, or other forms of employee ownership, might well be an effective way to advance the values underlying industrial democracy. There are at least two problems with this, though. First, unions (in the United States, at least), have generally not been open to involvement in managerial decisions, or ESOPs in particular.[175] Second, unions have been on a decades-long decline, perhaps irreversible. Thus, although advocates of industrial democracy should not give up on unions, they should explore other options as well. ESOPs are one such option.

Advancing industrial democracy does not seem to have been a major purpose of Congress in establishing ESOP laws. It does not show up in the legislative history, and it would be rather strange for Congress to advance such a fundamental and controversial goal through an obscure and little-noticed segment of tax and ERISA law. Moreover, as we have seen, ESOP law does not do much to encourage greater employee control, as opposed to ownership. Indeed, by creating a mechanism for greater management entrenchment, the law may do more to promote managerial control than worker control.

E. Goals worth pursuing

We thus see that at least two goals may justify promoting ESOPs: efficiency and democracy. Two other oft-cited goals, wealth equalization and capital formation, are weak justifications, so in what follows I will ignore them. Of the two potentially valid goals, efficiency is the least controversial: it was an actual goal of Congress, it tends to help (or at least not hurt) most in society, and it is a goal courts

[175] *See* Joseph R. Blasi & Douglas L. Kruse, *Strategic Problems and Tactical Promise: Unions and Employee Ownership,* 42 LABOR L. J. 498 (1991).

pursue in many contexts. It is also the standard goal of law and economics analysis. I shall thus consider it first and at greater length in what follows. But, democracy is also a fundamental value worth pursuing, and ultimately may represent the most compelling justification for ESOPs. We should not ignore it, and I will not.

V. A COMPARATIVE INSTITUTIONAL ANALYSIS

Having identified the values that might justify ESOPs, we now reach our core question: what legal approach to ESOPs is most likely to advance those values? What mechanisms can control management within a company where an ESOP owns a significant share of stock, particularly where the ESOP owns over half of the outstanding stock? We might look to markets, courts, executive agencies, legislatures, or to some combination of these, for help. In this section I analyze these various institutions and their abilities to do the job. Having done that, we can then ask how our legal institutions can best advance our goals, working within the broader social framework of these other institutions.

I draw on the comparative institutional analysis framework developed in Neil Komesar's *Imperfect Alternatives*. Komesar compares the relative strengths and weaknesses of markets, legislatures, and courts in achieving various policy goals, and stresses the need for a detailed analysis of the relative abilities of each for achieving any particular goal under given circumstances.[176]

Komesar's work strongly resembles the law and economics approach—indeed, it can be seen as a variant of law and economics.[177] His framework has two strengths I would like to emphasize and follow. First, he emphasizes the im-

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[176] *See* KOMESAR, *supra* note 11, at 5.

[177] Although it is possible to expand Komesar's framework by borrowing tools from other disciplines, such as sociology, political science, and psychology. For an argument on the desirability of doing so, *see* Edward L. Rubin, *Book Review: Institutional Analysis and the New Legal Process*, 1995 WIS. L. REV. 463 (1995).

portance of comparative analysis.[178] It is not enough, for instance, to argue that courts are unlikely to monitor managers well. One also needs to argue that other mechanisms, generally market-based ones, will do a better job, net their social costs. Law and economics scholars sometimes take this comparative approach—for instance, Frank Easterbrook and Daniel Fischel often do so in *The Economic Structure of Corporate Law*[179]--but the needed comparisons are ignored often enough that they bear emphasizing. Second, Komesar does not treat economic efficiency as the only desirable social goal. Even if one cares to achieve goals other than efficiency, economic analysis is still useful in predicting the outcome of various policy alternatives and evaluating how well different proposals are likely to achieve the desired goal.[180] Law and economics scholars tend to be exclusive in their focus on efficiency; I do not intend to follow them in that respect. In doing so, I also follow William Simon in recognizing that corporate law can be about politics and power, not just economics and contract.[181] Achieving economic and political democracy is an important goal to consider in analyzing ESOP law.

A. Courts

The plaintiffs in the cases we have considered tried to expand the role of courts in monitoring managers of ESOPs and their companies. Traditionally, courts have been reluctant to second-guess most business decisions. This reluctance is expressed as the business judgment rule.[182] The

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[178] *See* KOMESAR, *supra* note 11, at 5.

[179] *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 7, at 94.

[180] *See* KOMESAR, *supra* note 11, at 10.

[181] *See* Simon, *supra* note 9.

[182] "If directors are sued with respect to a decision they have made . . . the court will examine the decision only to the extent necessary to determine whether the plaintiff has alleged and proven facts that overcome the business judgment rule presumption that business decisions are made by disinterested and independent directors on an informed basis and with a good faith belief that the decisions will serve the best interests of the corporations. If the presumption has not been

main justification for that rule has been that courts are ill-equipped to judge what actions would best advance the interests of a business. Judges are lawyers, after all, not businessmen. They also do not have anything close to the amount of information available to managers. Furthermore, there's the danger of 20-20 hindsight vision—judges see a case after events have happened, yet they must try to determine whether an action was justified given the information available at the time of the decision.[183] These are among the factors that make courts poor critics of most business decisions. How is a court supposed to evaluate whether the incumbent managers of an ESOP are doing a good job in promoting the interests of the employee-owners, and whether someone else would do a better job? The question is particularly hard in evaluating a board election where no alternatives have been presented.

Nonetheless, it is not enough simply to point to the business judgment rule and the limited competence of courts. First of all, where conflicts of interest exist courts apply the stricter duty of loyalty.[184] In our circumstances there does appear to be at least a potential conflict, as managers may promote their own interests over those of the employees they represent. The best justification for the business judgment rule is not simply that courts are not likely to do well in monitoring managers. For the most part, market mechanisms do a pretty good job of constraining managers, and the cost of increased monitoring from courts is too high for the relatively meager additional benefits such monitoring provides.[185]

It is possible, however, that with an ESOP that controls a majority of a company's stock, the market mechanisms do not work nearly as well. We shall explore this possibility in

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overcome, then the business judgment rule prohibits the court from going further and examining the merits of the underlying business decision and prevents a factfinder, in hindsight, from second-guessing the decisions of directors." BLOCK, *supra* note 104, at 6 (citations omitted).

[183] *See id.* at 98-99.

[184] *See* BLOCK, *supra* note 104, at 262-62.

[185] *See id.* at 94.

the next subsection. Thus, although courts do not function well, perhaps they are better than the market alternative, or at least a useful supplement for the poorly functioning market in this area.[186] For instance, courts play a stronger monitoring role in applying fiduciary law when incumbent managers take defensive actions to ward off hostile takeover attempts, where market mechanisms may not function too well.[187] Perhaps fiduciary law in that context could be useful in considering the role of courts faced with ESOPs.

So far I have focused on the role of courts in monitoring how efficient managers are. We saw in section IV another value that may justify ESOPs, namely industrial democracy. Are courts likely to effectively promote this value? A key characteristic of courts is their relative independence from day-to-day political pressures.[188] Thus, if legislatures and agencies have biases against industrial democracy, courts could do better;[189] we shall explore those institutions in later subsections. The independence of judges allows them to give freer rein to their personal values. But, judges tend to be drawn from the social elite, and likely tend to identify more with managers than workers.[190] Moreover, courts and judges' chambers are not themselves model democratic institutions. We should, therefore, not really expect judges to be the best audience for industrial democracy advocates.

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[186] *See* KOMESAR, *supra* note 11, at 23 (stressing repeatedly that frequently circumstances in which one institution functions poorly are also circumstances in which others do poorly as well, so that the question then becomes which institution is least bad.).

[187] *See supra* section III.C.

[188] *See* KOMESAR, *supra* note 11, at 124-28.

[189] Though for courts to interpret statutes to advance a goal not supported by legislatures would be quite objectionable to many. Nonetheless, it would not be the first time judges used their interpretive powers to advance their own agendas, and some argue that if they advance the right values this may be appropriate in some circumstances. *See* ESKRIDGE, *supra* note 169.

[190] I know of no systematic evidence on this point, but it seems plausible.

Moreover, the process of going to court is not democratic. Courts require a formal, adversarial process, and judges (unelected, at least in federal court) get to decide the outcome.[191] Democracy involves more informal give and take. It can be adversarial, but it can also be more cooperative. In a democracy all participants can make their case, and then in the end all get a share in the decision-making through voting. In *Grindstaff*, the collective bargaining between NAC and the union at least was a process with some democratic elements. The move to court was a move to a much less democratic process.[192] Perhaps courts can serve a useful role in policing more democratic processes to make sure they function properly, but going to court itself is far from a democratic experience.

This analysis of courts suggests they are not an especially good institution for making ESOP companies more efficient or more democratic. We must reserve final judgment, though, until we have considered whether the alternatives do any better.

B. The market

The dominant view in law and economics scholarship treats corporations as a nexus of contracts.[193] It focuses on the agency problem that exists between shareholders and managers, and analyzes ways in which various market mechanisms help limit the misbehavior of managers. Although the analysis differs somewhat for public and closely held corporations,[194] for both types of ESOPs, holding a

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[191] *See* Austin Sarat, *Going to Court: Access, Autonomy, and the Contradiction of Liberal Legality, in* THE POLITICS OF LAW 97-114 (David Kairys ed., 3d ed. 1998).

[192] Although the pre-trial settlement process may often look more like political or workplace bargaining.

[193] *See* EASTERBROOK & FISCHEL, *supra* note 7, at 15-22.

[194] Closely held corporations feature few shareholders and thin markets, with each shareholder owning a relatively large share of the firm. Public corporations are the opposite, with many small shareholders, most or all owning only a tiny fraction of the outstanding shares, and a highly active market for trading shares.

large percentage of a company's shares can cause serious problems for the ordinary control mechanisms.

For large public corporations with many small stockholders there is a long literature going back decades fretting over the separation of ownership and control.[195] Shareholders face a free rider problem: each would prefer that the others engage in the costly monitoring of managers, and no one has adequate incentive to do so himself. Ordinary shareholder voting mechanisms probably do little to constrain managers of such companies.[196]

But, voting, along with the trading of shares, is important because it makes possible tender offers and hostile takeovers.[197] If incumbent managers are not maximizing the value of a company, and some outsider thinks she could do better, the outsider can offer to buy shares at a premium. If she thereby succeeds in gaining a controlling share, she can vote out the old directors. She can vote for directors that she prefers, and the new board can in turn replace the management. The mere threat of takeovers can help check mismanagement.[198] It is because defensive measures can seriously weaken this takeover mechanism that Delaware courts apply the heightened scrutiny discussed above in section III.C. The literature on takeovers is of course voluminous, and there is much disagreement over details and how much of a checking effect hostile takeovers have. But, the general drift of this literature is that takeovers are one important means of checking mismanagement.[199]

An ESOP can thwart this mechanism and become a takeover defense mechanism. The problem is particularly

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[195] The starting point is BERLE & MEANS, *supra* note 3.

[196] *See* John Pound, *Proxy Contests and the Efficiency of Shareholder Oversight*, 20 J. FIN. ECON. 237 (1988).

[197] *See* EASTERBROOK & FISCHEL, *supra* note 7, at 70-71.

[198] *See id.* at 173.

[199] For some summaries, *see id.* at 162-211. *See also* ROBERTA ROMANO *et. al.*, FOUNDATIONS OF CORPORATE LAW 229-300; RONALD J. GILSON & BERNARD S. BLACK eds., THE LAW AND FINANCE OF CORPORATE ACQUISITIONS ch. 10, 363-97 (2d ed. 1995).

acute where the ESOP owns a majority of shares, and the company's managers in turn control the ESOP. Such a company's management could be immune to a hostile takeover. Even where the ESOP owns less than a majority of shares, its existence can make it harder for a bidder to acquire a majority. True, in public companies there must be pass through voting on all votes for vested shares. Still, workers are often unlikely to vote in favor of a takeover out of fear for their jobs, and entrenched managers may control the votes of unallocated shares. The use of ESOPs as a takeover defense mechanism has aroused comment, both in the academic literature and in some court cases.[200]

Other markets besides the market for stocks with its associated takeover threat can help constrain managers. The managerial labor market gives managers a reason to perform well at their current job so that they can move on to a better one.[201] Of course, entrenched managers need not worry about being fired, so this is an incentive only for those who choose to leave, or who fear company bankruptcy. Moreover, hiring firms often can't tell how well one manager has done—even for high-level managers, the performance of their former firms is highly imperfectly correlated with how well the manager managed.

The need to raise money through debt also helps constrain managers. Debtholders may monitor firms directly, and they may impose various contractual constraints limiting misbehavior.[202] More deeply, the likely need to seek future financing helps rein in managers. In *Grindstaff* the

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[200] *See* Grannis, *supra* note 118; BLASI & KRUSE, *supra* note 5, at 139-210. The antitakeover effect of ESOPs would be less objectionable if they also allowed employees to become actively involved in checking managers in other ways. Unfortunately, they do not usually seem to do so, and thus one check on management is lost without a gain in other checks.

[201] *See* Eugene F. Fama, *Agency Problems and the Theory of the Firm,* 86 J. POL. ECON. 288, 295-306 (1980).

[202] *See* Michael C. Jensen, *Eclipse of the Public Corporation,* HARVARD BUS. REV. 61 (1989).

defendants claimed that they rejected pass through voting because their lenders would have disapproved.[203]

Another important market checking managers is the product market and the possibility of bankruptcy. If managers cannot offer products at a price which will sell and which yields revenues exceeding cost, eventually their company will go bankrupt. The managers must then seek a new job, and will have to explain to would-be employers how their company went bust. Alas, this constraint can take a long time to work, and the offending managers may be gone by the time bankruptcy hits.

Though product, debt, and managerial labor markets help constrain managers, they are all quite imperfect, and ESOPs can largely undercut the takeover mechanism. Do ESOPs facilitate any other market mechanisms of control? Workers themselves are potentially effective monitors. They know much about how a company is run and how it could be run better. Furthermore, they have incentive to persuade the company to try their ideas. This, indeed, underlies most efficiency arguments in favor of worker participation.[204] For public corporations, an ESOP must follow pass through voting on vested shares for all shareholder votes.[205] Thus, perhaps for public corporations the loss of

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[203] *See Grindstaff*, 133 F.3d at 419.

[204] *See supra* note 4.

[205] However, for unallocated shares, which can be quite a big chunk of the total, especially in the early years of an ESOP, the ESOP need not meet such requirements. If the trust votes the unallocated shares so as to mirror the vote of the allocated shares, then the possible check on managers remains. Some, though, have argued that such mirrored voting is inappropriate, as present holders of vested shares may have interests that differ from future voters. Moreover, workers tend to vote in favor of management and against takeovers. *See* Grannis, *supra* note 118. The Department of Labor apparently takes this position as well, and the First Circuit has endorsed it, at least where employee-owners are not given notice that their votes will affect the votes of unallocated shares. *See Herman*, 126 F.3d at 1368. Perhaps, but where managers perform the fiduciary voting, it seems to me that mirrored voting is more likely to reflect the interests of future participants, and certainly more likely to avoid managerial entrenchment, than is allowing managers

the takeover threat is at least partially compensated for by employee-shareholders monitoring management. Whether this really happens is a tough empirical question. Effective worker monitoring probably requires more active participatory mechanisms than shareholder voting alone.

For closely held corporations the analysis differs somewhat. In most circumstances the takeover mechanism does not exist to help constrain managers. However, usually the separation of ownership and control is much less severe. There are a few owners with large stakes in the company, and these owners manage the company, or have strong control over the managers and incentive to exercise that control.[206]

However, an ESOP structure may recreate the separation of ownership and control, as company mangers control the ESOP's votes but do not receive the income from the shares. The lack of a takeover threat hence becomes much more serious. The other mechanisms mentioned above—managerial labor markets, debtholders, product market, and bankruptcy—may help constrain managers to some degree. Employee monitoring may work <u>if</u> the ESOP provides for pass through voting, but the law only requires this in closely held corporations for votes on fundamental corporate changes, and most firms with ESOPs do not provide for pass through voting on other matters.[207] It is ironic that the law requires pass through voting only for restructurings, where employees are more likely to support managers, and not in other matters where employees might play a more active role.

Unions provide one other possible means for checking management, and for inducing a firm to adopt an ESOP structure giving workers more of a say.[208] Indeed, in *Grind-*

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discretion in how to vote unallocated shares constrained only by a fiduciary duty enforced by courts.

[206] *See* EASTERBROOK & FISCHEL, *supra* note 7, at 228-29.

[207] *See* BLASI, *supra* note 6, 167-68.

[208] *See* Elana Ruth Hollo, *Note, The Quiet Revolution: Employee Stock Ownership Plans and Their Influence on Corporate Governance,*

staff the union was the main voice pushing for more employee control. However, *Grindstaff* also illustrates that unions often lose to management. More importantly, most workers in the United States do not belong to a union.[209] Moreover, unions have generally not been receptive to ESOPs, and hence cannot usually be counted on to advocate more powerful ESOPs.

Thus, although many of the market mechanisms for controlling management misbehavior remain in place, the ESOP does pose a threat to an important one for public corporations, the hostile takeover, and in close corporations an ESOP may create a separation of ownership and control. The market is thus often less effective in constraining managers and promoting efficiency for an ESOP-controlled corporation than it is for corporations without ESOPs. For ESOPs like Demoplace Corp., worker involvement will provide an alternative method to monitor managers, but for Managers, Inc. there is nothing like that.

Our other value of interest is industrial democracy. How well does the market promote that? Market advocates typically maintain that if worker-controlled firms are efficient, they should flourish in a free market economy. Even if they are less efficient than other firms, if workers value democracy they can take a cut in pay to work in a cooperative.[210] In section IV.C. I suggested various reasons this might not be true. Uncertainty, increasing returns due to learning effects, imperfections in capital markets, gaps in corporate law, a biased educational system, and cultural factors are among the many reasons markets may not always give the most efficient and desirable outcome. It is of course a big question, and one well beyond the range of this paper, how important such factors actually are. As suggested above, this is quite a difficult issue, and one that has not been satisfactorily addressed in many contexts. Note

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Labor Unions, and Future American Policy, 23 RUTGERS L.J. 561 (1992); Blasi & Kruse, *supra* note 175.

[209] *See* Blasi & Kruse, *supra* note 175, at 175.

[210] *See* Jensen & Meckling, *supra* note 162.

too that even if the conditions for lock-in exist, it is quite possible that we have locked-in to the most efficient alternative. Moreover, even if the mechanisms leading to possible inefficiencies are important, that is not yet a sufficient argument for governmental intervention in favor of employee ownership—one of the important lessons of comparative institutional analysis. That is true even when we recognize industrial democracy as a value quite separate from efficiency.

Within an economy like ours where ESOPs are usually created by the managers of hierarchical firms rather than by the employees of initially democratic firms, will market forces push firms towards greater democracy in their use of ESOPs? There might be an exit mechanism, where workers are drawn to firms with more democratic ESOPs.[211] That, though, is subject to the sorts of objections discussed in the last paragraph. Unions could provide a voice mechanism supporting industrial democracy, but as already noted, they have so far proven reluctant to do so, and anyway are a nonexistent voice in most workplaces.

Thus, markets do seem to have added problems regulating companies with ESOPs. The takeover mechanism is weakened for public corporations, and separation of ownership and control may be created in closely held corporations. Many control mechanisms are still in place, such as debt, product, and managerial labor markets. In some ESOPs, active worker involvement may provide a new control mechanism. The effect of ESOPs on market mechanisms is thus not totally clear, in direction or size. We must continue our tour of possible institutional alternatives.

C. Agencies

Executive branch agencies are another institution that conceivably could control wayward management. The main agency of interest here is the Department of Labor. In

[211] *See* HIRSCHMAN, *supra* note 152 (discussing exit as opposed to voice).

Grindstaff and *O'Neill* the Department entered only indirectly, as one source suggesting how the court should interpret the law.[212] No one seems to have suggested that the Department should supervise elections in ESOP firms and certify whether the decisions of management are fair to workers, although this is a logical possibility. The Department does play some role in related areas of ESOP law. In particular, when companies first issue stock to an ESOP the Department examines the issue and determines whether the company has fairly priced the stock—incumbent managers often have an incentive to overvalue the stock, causing the ESOP to pay too much to the company.[213]

Agency bureaucrats typically have more expertise in the area they regulate than generalist judges. However, this expertise comes at a price. Bureaucrats are less independent than judges, and more subject to lobbying, as they repeatedly make decisions in the same area. Bureaucratic regulation also tends to be more intrusive than judicial monitoring, as regulation involves review of all transactions of a certain type, whereas courts only get involved in those instances where disputes arise.[214]

In the case at hand, there is perhaps less room for specialized competence than in many instances of regulation. Whether an ESOP fiduciary has voted stock shares wisely will depend on very different considerations for different companies in different circumstances. The Department of Labor probably does not have much particular expertise in answering such questions.

It is unclear whether the Department is likely to be captured by particular interests pulling in any one direction.[215] Labor unions would seem the constituency most likely to

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[212] *See Grindstaff*, 133 F.3d at 424; *O'Neill*, 721 F.Supp. at 1015.

[213] *See* Ezra S. Field, *Note, Money for Nothing and Leverage for Free: The Politics and History of the Leveraged ESOP Tax Subsidy*, 97 COLUM. L. REV. 740 (1997).

[214] *See* Steven Shavell, *Liability for Harm Versus Regulation of Safety*, 37 J. LEG. STUD. 357 (1984).

[215] *See* Field, *supra* note 213 (discussing lobbying in a related area of ESOP law).

capture the Department. One would expect that the civil servants drawn to the Department would tend to be sympathetic to union concerns. However, employer groups are also likely to lobby the Department, and employer associations are in general the most successful and powerful segment of political lobbyists. Much probably also depends on which party controls the White House, and hence is able to make high level appointments. Insofar as labor groups have a strong influence, that might suggest that the Department could effectively pursue the ideal of industrial democracy; however, given the relative coldness of unions to ESOPs, it is not clear if that is true.

Even if the Department of Labor is not a terribly attractive candidate for regulating the actions of ESOP fiduciaries in voting ESOP shares, it might be a more attractive candidate for deciding how ERISA should be interpreted—the *Chevron* argument. The Department does have much expertise in the functioning of ERISA, which it supervises. The over-regulation by bureaucracy problem is much less severe for this meta-question, where the Department is not being asked to regulate ordinary business decisions of fiduciaries, but rather being asked its advice in how far courts should go in enforcing the fiduciary duty.

For this point too it is unclear whether labor or management has captured the Department. One would be at least somewhat less worried about the possibility of capture if the agency were forced to go through a more formal rulemaking process of soliciting input from all interested parties and then defending its position with publicly-stated reasons in order to announce a position.

D. Congress

From the argument so far it would appear desirable for Congress to amend the laws affecting ESOPs. On either efficiency or industrial democracy grounds it is hard to defend subsidies for ESOPs where the employees do not have full control voting the ESOPs' shares. Perhaps subsidies are not justified even with such control; without it, the sub-

sidies make little sense. The right the *Grindstaff* plaintiffs struggled unsuccessfully for is a right that should be present in all tax-favored ESOPs. This would lead to fewer ESOPs, but those left would be better ones.

So would those who agree with the *Grindstaff* plaintiffs be well advised to concentrate on changing federal statutes? Good luck to them—they're going to need it. It is not enough to say there ought to be a law—one must examine the underlying political forces and judge whether Congress is likely to pass that law. It is not clear how the improved law I suggested would be passed.

ESOP law may well be an example of how a law becomes entrenched. Although the ESOP rules do seem to aid managerial entrenchment, there does not seem to have initially been a great demand from groups representing managers for these rules.[216] The ESOP rules seem largely to have resulted when one man, Louis Kelso, convinced one influential senator, Russell Long, that they would be a good idea. The rules were passed with little controversy, buried in obscure parts of the tax code and ERISA.[217]

Once passed, though, the ESOP rules built a constituency. Kelso's company and others started promoting ESOPs, and gradually companies adopted them. Managers in firms with ESOPs, along with the investment bankers who design and promote them, now have an interest in preserving the law, and encouraging more ESOPs. These groups will lobby to prevent change, as they did in 1986.[218]

On the other side, there's little sign of any concentrated group likely to push for reform. Unions are the most likely candidate, but so far they have been more interested in burying or ignoring ESOPs than in improving them.[219] Absent a change of heart, they seem unlikely to be the impetus for change. Moreover, ESOPs are not an issue of major public interest, so it is the sort of topic likely to be domi-

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[216] *See* BLASI, *supra* note 6, at 18-22.

[217] *See id.*

[218] *See id.* at 154-57.

[219] *See supra* note 175 and accompanying text.

nated by special, concentrated interests. Perhaps the interests on both sides are weak enough that politicians could be persuaded to follow a good policy analysis, as the electoral and fundraising consequences of doing so may be slight. Perhaps, but I am not holding my breath.

Which legal approach is likely to achieve the best outcome? What legal approach is most likely to advance the goals of increasing efficiency and productivity or industrial democracy? Section III laid out two basic alternatives in a case where ESOP managers have voted ESOP stock shares in a board election to entrench their own position as company managers. One alternative demands that plaintiffs must show something more than such a vote in order to state a claim.[220] The other alternative would allow plaintiffs to state a claim simply by showing that there was such a vote, and the managers would then have the burden of producing evidence that their action was well-informed and/or reasonably in the interest of employee-shareholders. The latter alternative involves more intrusive court scrutiny of the voting decisions of ESOP managers.[221] We have seen that some market mechanisms which constrain managers are considerably weakened, if not eliminated, for companies where ESOPs control a significant share of the stock but employees are not actively involved in deciding how the ESOPs' shares are voted, although other sorts of market mechanisms do remain in place—the market for managers, the product market and bankruptcy, monitoring by debtholders, and so on. Moreover, regulation and oversight by the Department of Labor is not a particularly attractive alternative, and Congress appears unlikely to modify the objectionable elements of ERISA law in the foreseeable future. Thus, there is room to argue for a rather active judicial role in applying the current law.

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[220] What that something more might be is a major question.

[221] Although the real differences might shrivel if the something more, which must be pleaded under the first alternative, is not much more.

But, as usual, courts are not likely to be very good at second-guessing the ordinary business decisions of managers. In *O'Neill* the court faced an internal struggle between existing managers—how is it to resolve that? How are federal judges supposed to say who would be the best members of a company's board? Moreover, managers would be likely to respond to a strengthened fiduciary duty by building a record showing they have inquired diligently into alternatives, and then voting for themselves anyway. In most cases they will be able to cite plausible reasons for voting for themselves, and so long as they have followed an adequate procedure, courts will go along. Requiring more would in most cases probably lead to wasted resources. There's no point getting federal courts involved unless plaintiffs can plead somewhat more serious wrongdoing than the vote itself. A number of market mechanisms constraining managers do remain.

However, what the "plus" of "entrenchment plus" might be is an interesting and important question. Given the greater weakness of market controls in these cases, that plus might be less than is required to invoke heightened scrutiny in other contexts. Perhaps that is the best way of understanding Judge Krupansky's dissent in *Grindstaff*--he thought the plaintiffs had pleaded something more, even though he is pretty vague as to what that might be.[222] Perhaps directors voting for themselves in a *contested* election should trigger heightened scrutiny, though that is a marginal instance for doing so. The heightened scrutiny that follows, though, should not be the strict scrutiny of examining the board's decision for its entire fairness, which arises upon a showing of circumstances demonstrating a conflict of interest. Rather, intermediate scrutiny along the lines of the second and third prongs of *Leigh* should apply: managers would have to show independent investigation and a reasonable relation to the interest of employee-shareholders to justify a decision that evokes this scrutiny.

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[222] *See Grindstaff*, 133 F.3d at 433 (Krupansky, J., dissenting).

The more aggressive second alternative, invoking heightened scrutiny whenever ESOP trustees vote for themselves, might seem better as a means of promoting industrial democracy. If, however, I am correct in predicting that companies would respond with a relatively empty form of due diligence, that is not so. A more aggressive judicial approach, moreover, might act as a lure bringing plaintiffs into federal court. Federal court is probably not the best place to fight battles for industrial democracy. Though the union in *Grindstaff* was on the right track in seeking greater control over ESOP votes, perhaps democracy would be better served had the union remained in the workplace and increased its efforts to organize and engage workers and negotiate with managers to achieve its goal.

VI. CONCLUSION

The message of this analysis is in some ways rather discouraging. Federal ESOP law allows, even encourages, managers to give workers ownership of shares in their companies while the managers retain control for themselves, significantly weakening market constraints on those managers without correspondingly increasing the potential for employees themselves limiting managers. Courts are highly limited in how effectively they can provide helpful extra constraints. This state of affairs does nothing to plausibly advance any desirable general goals, and yet Congress appears unlikely to change the laws any time soon.

Yet, all is not doom and gloom. For one, courts can help, albeit in a very modest way. Where management behavior raises enough concern to trigger heightened scrutiny, the courts might have some deterrent effect. Our doctrinal and policy analyses both suggest that after a showing of "entrenchment plus," the burden should shift to defendant managers to justify their decision to vote for themselves, by showing adequate investigation and a reasonable relationship between their decision and the interests of employee-owners. The resulting scrutiny would be intermediate be-

tween the normal business judgment rule and the heightened scrutiny under the duty of loyalty. Such mid-level scrutiny would probably lead to relatively few plaintiff victories, but the threat of submitting to such scrutiny may force managers to be somewhat more cautious than they otherwise might be in entrenching themselves. It is not a lot, but even a little helps.

Furthermore, perhaps the long-term prospects for reforming the law are not quite so bleak. If unions were to become involved in this issue, they would probably have a decent chance at persuading Congress to reform the law. The most obvious reform is requiring pass through voting on all shareholder votes for all ESOPs which receive tax breaks, perhaps combined with proportional voting for unallocated shares. Although the current law has created some institutional support for itself, that support is not so strong that it could clearly defeat the still-considerable clout of unions. Perhaps the least likely part of this scenario is getting unions interested in the issue. For many decades American unions have focused on wages, benefits, and jobs, and left issues of control of the workplace to management.[223] But the steady decline of unions, combined with changes in how work is organized, could conceivably induce the union movement to reevaluate this strategy. If so, reforming ESOP law would be one natural area for unions to consider.

The potential political base for more democratic ESOPs goes beyond unions. In the United States, with President Clinton and the Democratic Leadership Council, and in Europe with various social democratic and socialist leaders, such as Tony Blair in Great Britain, there has been discussion of a "third way" between traditional statist socialism and untrammeled capitalism, a way more responsive to modern economic realities than the increasingly hoary welfare state. Expanded worker ownership fits snugly with such an intermediate political vision. Worker ownership

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[223] *See* Karl E. Klare, *Critical Theory and Labor Relations Law*, in THE POLITICS OF LAW 539, 561-63 (David Kairys ed., 3d ed. 1998).

focuses on action through the market, rather than through the state, yet it somewhat equalizes the balance of power from that found in pure capitalism. Expanded encouragement of more democratic ESOPs can be a means for third way politicians to nudge along the market a bit.

Perhaps most importantly, even if the law remains unchanged much good can be done within that law. Although the current law does little to actively encourage greater worker participation and control, it does create space for it. Activists could focus on creating more Demoplace Corps, even though the Managers, Inc.'s of the world will not disappear. A minority of ESOPs have combined ownership with greater employee participation, and these have tended to be more economically successful than other ESOPs.[224] The subsidy provided ESOPs under current tax law can help to counter-balance the disadvantages of trying to establish more worker control within an environment where such control is rare.[225] That is not the intent behind the law, but that law can be harnessed to unintended ends.

Thus, perhaps advocates of workplace democracy should focus their efforts outside the political sphere. Too many advocates of greater equality and social justice are addicted to schemes involving more government. The experience of every-day, lived-out democracy is best gained through local activity and smaller institutions, not centralized government agencies. Activists unhappy with the current way of doing things, then, may be best advised to use existing ESOP law to create more Demoplace Corps, rather than trying to fight Managers, Inc. in court.

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[224] See *supra* note 155 and accompanying text.

[225] *See* Alan Hyde, *Ownership, Contract and Politics in the Protection of Employees Against Risk*, 43 U. TORONTO L.J. 721, 736 n.57 (1993).