www.americanbar.org/rpte
January/February 2017 Vol. 31 No. 1

Probate & Property

A Publication of the Real Property, Trust and Estate Law Section ABA American Bar Association

Analyzing Easement Laws

Richard Diebenkorn, *Cityscape #1*, 1963
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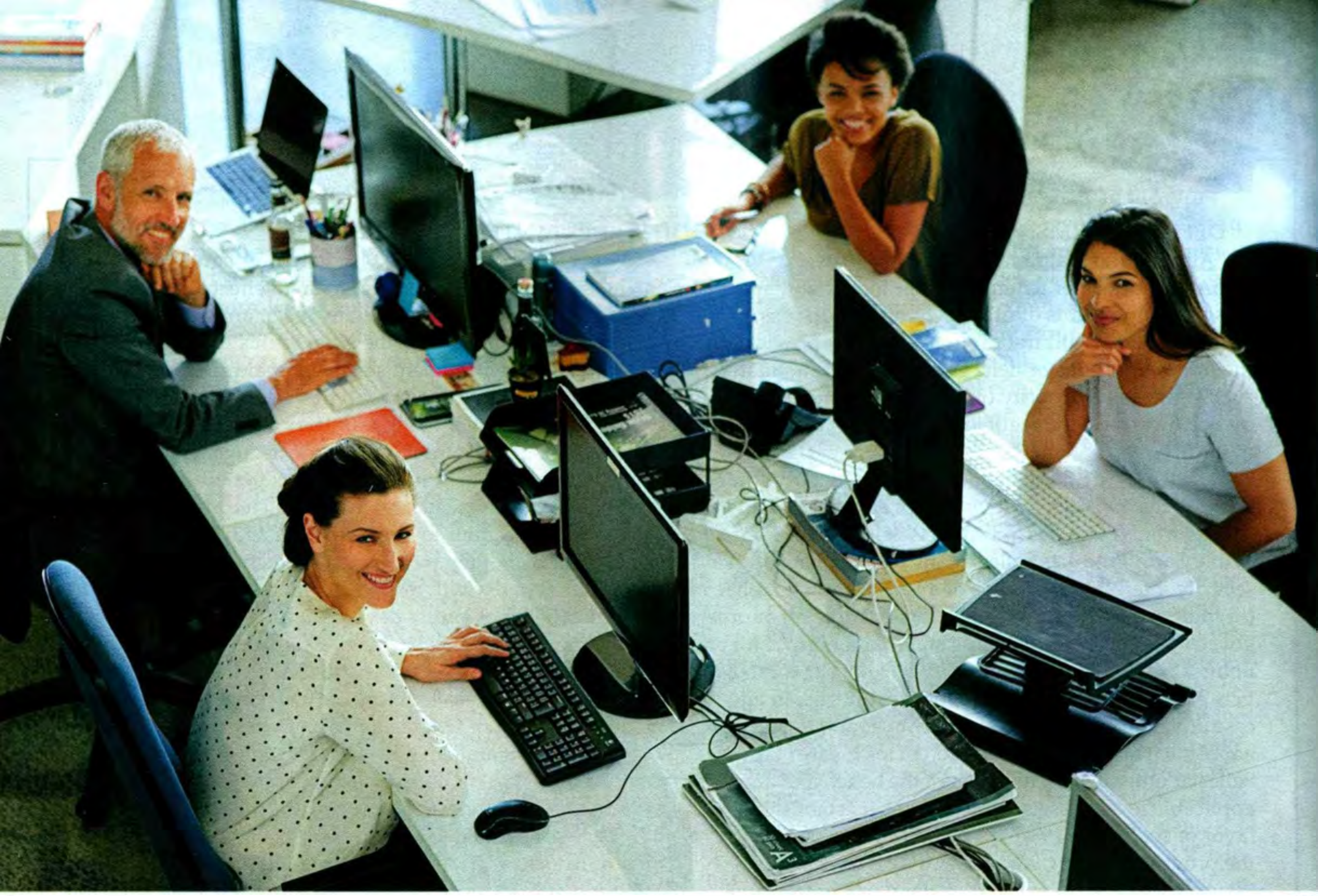

The Employee Ownership Trust, an ESOP Alternative

By Christopher Michael

For the last four decades, an employee stock ownership plan (ESOP) has been the optimal legal mechanism for transferring ownership of stock to employees in the company in which they work. A primary goal of ESOPs is often long-term employee ownership, as an ongoing employee reward program that leads to improvements in productivity and profitability and helps to ensure the longevity of the company. Unfortunately, the laws applicable to ESOPs have not kept pace with evolving trust law. In particular, legislators have not adapted ESOP policy to states' widespread reform of the rule against perpetuities. Even in states that have eliminated the rule against perpetuities, the "exclusive benefit" rule imposed by federal law requires ESOPs to prioritize employees' retirement income at the expense of employees' continued ownership of their business and thus prohibits a perpetual ESOP trust. As such, ESOPs are an uncertain vehicle when it comes to safeguarding the ownership of a firm by its employees. The ESOP structure is also exceedingly complex, which warrants additional concern. This article discusses perpetuity and other related problems with ESOPs and introduces the employee ownership trust (EOT) as a viable alternative.

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Development of ESOPs

The ESOP was developed in the 1950s by a San Francisco lawyer named Louis Kelso. An ESOP is an employee benefit program under which employer stock is transferred to individual employee accounts within a tax-exempt trust. The employer is required to repurchase an employee's

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shares on his or her retirement. In 1974, Kelso worked with Senator Russell Long to pass legislation under the Employee Retirement Income Security Act (ERISA) that gives special status to ESOP trusts. Unlike other qualified retirement plans, ESOPs may borrow from an employer for the purchase of employer shares. 29 U.S.C. § 1108(b)(3). Over the ensuing years, additional benefits were conferred under the Internal Revenue Code, including capital gains deferral for owners who sell shares to an ESOP trust and reinvest sale proceeds in domestic securities. IRC § 1042. In recent years, many S corporations have opted for 100% employee ownership, as such companies are effectively tax-exempt because of the combination of pass-through tax treatment and the tax-exempt status of the ESOP trust. IRC §§ 501(a), 401(a), 1361(c)(6).

As a direct result of ESOP legislation, the United States has demonstrated that employee ownership can be a mainstream phenomenon. Today, 11% of the private-sector workforce (13.5 million employees) participates in an ESOP at 7,000 companies. Nat'l Center for Emp. Ownership, *ESOP (Employee Stock Ownership Plan) Facts*, www.esop.org (last visited June 24, 2016). And approximately 1.5 million Americans work at 4,000 majority employee-owned businesses. ESOP plans exist in nearly every industry and at companies of all sizes. The largest majority ESOP company is Publix Supermarkets with over 180,000 employees. These figures are unparalleled in other major industrialized nations, and constitute a significant advance over previous historical periods. See generally Joseph R. Blasi, Richard B. Freeman & Douglas L. Kruse, *The Citizen's Share*, 159–66 (2013). And yet, these achievements are the consequence of a modest formula—a package of financial incentives for business owners and companies—that has enjoyed bipartisan support in Congress for the last 40 years.

Naturally, four decades of ESOP practice have also yielded lessons and opportunities for improvement. Central concerns for many founders, employee-owners, employee ownership advocates, and ESOP professional service providers include the longevity of the ESOP structure itself, as well as its complexity. In the typical ESOP transaction, a retiring business owner aims to reward his or her employees and preserve the legacy of his or her business. The fiduciary duties of ESOP trustees, however, require the sale of an ESOP's stock on receipt of a profitable offer—which may be a boon to a single generation of employees, but eliminates ownership for future employees and diminishes the founder's legacy. Moreover, structuring the ESOP transaction is time-consuming and involves a significant learning curve, a feat that can be difficult for retiring owners. Although some business owners and managers embrace the technical side of ESOPs, many more retiring owners and estate advisors prefer to avoid the tightly regulated domain of ERISA trustee standards, employee share repurchase schedules, and an obscure section of the federal tax code.

Evolving Trust Law

In the postwar period, federal legislation supported the expansive growth of employee trusts. Yet, federal policy preceded an adequate state law framework. Vesting issues (with respect to future employees) threatened the trusts' viability under the common law rule against perpetuities. Christian Marius Lauritzen II, *Perpetuities and Pension Trusts*, 24 Taxes 519, 520–21 (1946). By 1950, the pensions of 7 million employees were jeopardized by this "serious legal problem." Article, *Insulating Pension Benefits from Creditors*, 3 Stan. L. Rev. 270, 279 (1951). At the same time, commentators were "unanimous in the view" that employee trusts should be exempted from the rule on policy grounds. Note, *Legal Problems of Private Pension Plans*, 70 Harv. L. Rev. 490, 493 (1957); see generally Lauritzen, supra, at 524–30. The states responded in due measure. By 1956, "[a]bout three-fourths of the states ha[d] adopted statutes exempting employee benefit trusts from . . . the Rule Against Perpetuities." Robert J. Lynn, James W. Foreman & William W. Wehr, *The New Inheritance: Employee Benefit Plans as a Wealth Devolution Device*, 11 Stan. L. Rev. 242, 254 (1959).

Of course, beginning in 1983 with South Dakota, a majority of states altogether eliminated, or substantially modified, the rule against perpetuities. S.D. Codified Laws § 43-5-8; accord Del. Code Ann. tit. 25, § 503; N.J. Stat. Ann. § 46:2F-9. In so doing, these states allowed the possibility of perpetual (or dynasty) trusts for any number of trust purposes. Perpetual trusts are now commonplace and simple.

The employee ownership policy enacted by Kelso and Long in 1974 did not fully leverage the availability of perpetual employee trusts across the United States. Neither did ESOP law incorporate advances in dynasty trust law more generally over the ensuing 40 years. Under current law, a trust provision that instructs an ESOP trustee to hold employer shares in perpetuity, thereby establishing a lasting program of employee ownership at the company, would conflict with the "exclusive benefit" rule under Title I of ERISA.

The "Exclusive Benefit" Rule

Under ERISA, ESOP fiduciaries must act with "the exclusive purpose of: (i) providing benefits to participants [employees] and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan." 29 U.S.C. § 1104(a)(1). For many years, discrepancies between the Department of Labor (DOL), the IRS, and federal courts permitted a range of opinion as to the types of benefits permissible under the law. According to a 1992 memorandum, the DOL and the IRS objected to a plan that incorporated nonfinancial benefits, such as "job security," "conditions of employment," "employment opportunities," and "the prospect of the Participants and *prospective* Participants for future benefits under the Plan." IRS Gen. Couns. Memo., No. 39,870, at

2–3 (Apr. 7, 1992) (emphasis added). In a 1994 bulletin, the DOL issued a slightly more flexible interpretation that allowed for the consideration of collateral benefits "that were not related to the plan's expected investment return, only if such investments were equal or superior to alternative available investments." *Interpretive Bulletin Relating to the Employee Retirement Income Security Act of 1974*, 59 Fed. Reg. 32606-01, at 32,607.

In contrast, a majority of federal circuit courts adopted a fiduciary standard that (1) acknowledged Congress's goal of encouraging employee ownership through ESOP formation; (2) questioned the extent to which ESOPs are purely investment vehicles; and (3) reflected an understanding of ESOP legislation as a carve-out within the broader framework of ERISA. *Lanfear v. Home Depot, Inc.*, 679 F.3d 1267, 1278–79 (11th Cir. 2012); *Moench v. Robertson*, 62 F.3d 553, 568-72 (3d Cir. 1995); *Donovan v. Cunningham*, 716 F.2d 1455, 1466–67 (5th Cir. 1983).

Ultimately, a recent opinion by the U.S. Supreme Court clarified that ERISA benefits do not include "nonpecuniary benefits like those supposed to arise from employee

ownership of employer stock." *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459, 2468 (2014). Rather, the "exclusive benefit" rule "must be understood to refer to the sort of *financial* benefits (such as retirement income) that trustees who manage investments typically seek to secure for the trust's beneficiaries." Id. Thus, current law prohibits ERISA trustees from prioritizing nonfinancial benefits, such as working conditions, job security, or employee ownership, as "a goal in and of itself." *Moench*, 62 F.3d at 568. As such, existing fiduciary standards under ERISA would override a perpetuity provision in an ESOP trust document.

Additional Concerns

Even if ESOP policy in fact embraced nonfinancial benefits, thereby allowing perpetuity as a valid term of an ESOP trust, an additional problem would still threaten perpetual employee ownership. Under the common law, beneficiaries may dissolve a trust by unanimous consent. Thus, employee-beneficiaries of an ESOP could attempt to "bust the trust."

An even more recent development in trust law eliminates the requirement of a trust beneficiary and allows grantors to establish a trust with a noncharitable purpose. Of course, the law has long permitted trusts dedicated to charitable purposes, but noncharitable purpose trusts are new. Originally authorized in foreign territories such as Jersey and Bermuda, U.S. states witnessed a wave of purpose trust legislation in the last decade. Del. Code Ann. tit. 12, § 3556; Mass. Gen. Laws Ann. ch. 203E, § 409; S.D. Codified Laws § 55-1-20. Purpose trusts are now also included in the uniform trust code as model legislation recommended for adoption by all U.S. states. Unif. Trust Code § 409. In light of late-20th-century and 21st-century developments in trust law, a moderate improvement to ESOP law would allow founders to leverage jurisdictions, such as South Dakota or Delaware, that permit both dynasty and purpose trusts. Founders would then be able to achieve the strongest guarantee for perpetual employee ownership as a purpose of an ESOP trust.

Yet even then, another obstacle arises in the context of minority ESOP-owned businesses. A company may choose to refrain from contributing new shares to an established ESOP. This is not often a real-world problem, as employers typically "recycle" shares back into the plan. But absent fresh contributions of employer stock, a minority ESOP will terminate after the exit of all current employee-participants. A solution to this problem would require further legislative action.

As illustrated, ESOP law, which continues to recognize only financial benefits, treats an ESOP trust purely as a retirement vehicle. This purpose contrasts with Congress's intended use of the ESOP trust as a vehicle for employee ownership. *Martin v. Feilen*, 965 F.2d 660, 664 (8th Cir. 1992). The tension between these purposes argues for alternatives to an ESOP trust that do not involve such a conflict. To this end, American and British history reveals a tradition of employee ownership that pre-dates Kelso and ERISA, and, in turn, offers a workable solution.

Traditional Employee Ownership

Over 150 years ago, a popular conception of employee ownership developed in the United States and United Kingdom as a widely-shared response to the rise of the modern corporation, large-scale centralized manufacturing, and capital-intensive technologies. Government officials, academics, business elites, and working people on both sides of the Atlantic, of disparate professional and class backgrounds, believed that employee ownership was a moral imperative and an essential measure of human and industrial progress.

John Stuart Mill, the influential philosopher, political economist, and member of Parliament, was the most notable 19th-century advocate of employee ownership. Mill was frequently quoted by contemporaries for his belief that employer-owned firms would "be gradually superseded by partnership, in one of two forms: in some cases, association of the labourers with [employers]; in others, and perhaps finally in all, association of labourers among themselves." John Stuart Mill, *Principles of Political Economy*, at IV.7.14 (William J. Ashley ed., Longmans, Green and Co., 7th ed. 1909) (1870). He thought that employee ownership was not only inevitable, but held the potential for:

> a change in society, which would combine the freedom and independence of the individual, with the moral, intellectual, and economical advantages of aggregate production; and . . . realize, at least in the industrial department, the best aspirations of the democratic spirit, by . . . effacing all social distinctions but those fairly earned by personal services and exertions.

Id. at IV.7.62.

Echoing popular sentiment, Mill felt that an economic system in which employee ownership was the predominant structure "would be the nearest approach to social justice, and the most beneficial ordering of industrial affairs for the universal good, which it is possible at present to foresee." Id.

At heart, Mill's views, and the views of like-minded Americans and Brits, were sustained by a fundamental belief that:

> intelligent, educated labor possesses the capacity for the accomplishment of any undertaking or enterprise, and need not wait for an individual called an employer to associate its effort, and direct and control the industry out of which it earns wages and pays premium to capital. . . . Intelligent labor need not wait until some [person] has hired it. It can . . . employ itself.

Bureau of Labor Statistics, State of California, *Third Biennial Report*, at 324 (1888).

The preceding passage was authored by U.S. Senator, railroad magnate, and founder of Stanford University, Leland Stanford. At the time, he was writing from his seat in the U.S. Senate in support of model employee ownership legislation for the District of Columbia. 49th Cong. (1886).

Employee ownership was synonymous with a culture of personal responsibility, industrial harmony, workplace health and safety, individual dignity, just compensation, and temperance.

Traditional principles of employee ownership, as advocated by Mill, Stanford, and many others, involve profits, voting, and culture. Reformers were particularly interested in the fair distribution of profits, and tended to praise financial structures that rewarded employees on the basis of labor input. Voting rights were pervasive in definitions of employee ownership, and employee-owned firms were understood to be enterprises in which employees elected the board of directors, and voted on shareholder issues, on a "one person, one vote" basis. Mill, supra, at IV.7.21. Finally, employee ownership was synonymous with a culture of personal responsibility, industrial harmony, workplace health and safety, individual dignity, just compensation, and temperance. When employees made a financial investment in the firm, being issued a fair reimbursement upon exit was a matter of due course. The primary aim of employee ownership, however, was not to generate a profit for exiting employee-owners.

Perpetual Trusts: Flexibility, Efficiency, and Accountability

Perhaps more in line with these traditional principles of employee ownership is the employee ownership trust. One of the mainstream forms of employee ownership in the United Kingdom, an EOT does not involve assigning and repurchasing shares for individual employees. Rather, stock is transferred to a perpetual trust and administered on behalf of all present and future employees. The best example of an EOT is John Lewis Partnership. Originally founded in 1894, the popular British retail chain employs 91,500 associates and has been held in trust for its employees since 1929.

John Lewis, unlike an ESOP company, has no obligation to repurchase the stock of individual employees. Instead, employees are "naked in, naked out." They earn a percentage of profits while working at the firm but exit without realizing any growth in the firm's value, much as in a law partnership. John Lewis also has a constitution that accords voting rights to all of its employees, empowering them to elect the firm's governing body. The Constitution of the John Lewis Partnership (June 2015), https://www.johnlewispartnership.co.uk/about/our-constitution.html (last visited Oct. 21, 2016). Finally, John Lewis trustees are required to preserve the business and its employee-owned structure for the benefit of the employees—a benefit that is understood to include both financial and nonfinancial elements and is best expressed in the culture of the firm, that is, the quality of working relationships among employee-owners.

In the United States, an EOT is able to give voting rights to employees by means of a power to direct the trustee. This power can be as narrowly or widely tailored as the settlor wishes. In this way, current employees can be granted effective control of high-level decisions, such as electing board directors and voting on shareholder issues, while maintaining trustee discretion over critical matters, such as the sale of the company and its substantial assets. Some states, like South Dakota and Delaware, have directed trustee statutes that not only allow such a bifurcation but also allow trust planners to substantially limit the liability of directed trustees. Del. Code Ann. tit. 12, § 3313(b); S.D. Codified Laws §§ 55-1B-2, -5.

Planners should keep in mind that ERISA specifically excludes trusts that do not systematically defer income until retirement. 29 U.S.C. § 1002(2)(A); *McKinsey v. Sentry Ins.*, 986 F.2d 401, 405–06 (10th Cir. 1993); *Murphy v. Inexco Oil Co.*, 611 F.2d 570, 574–76 (5th Cir. 1980). As such, perpetual employee ownership can be achieved today, without any regulatory or legislative changes, by means of establishing an EOT in a perpetual and purpose trust jurisdiction. An EOT can be used for both minority and majority ownership of a company, and nothing precludes the combination of a majority EOT (for perpetuity) and a minority ESOP (for tax benefits).

Of course, no business lasts forever. EOTs should have an independent co-trustee or trust protector that can approve the liquidation or sale of the company when the close of the business is unavoidable. This function is strengthened when the co-trustee or trust protector is (1) appointed on creation of the trust; (2) not subject to employee election or recall; and (3) self-appointing with respect to successor co-trustees or trust protectors. Under the terms of the trust, the principal might be reserved for distribution to an organization that supports employee ownership.

An additional benefit of the EOT is that certain "constitutional protections" can be locked into the structure. For example, the EOT might require the company to (1) safeguard earnings by fixing base compensation in line with market rates; (2) retain a percentage of annual net income as permanent reserves; (3) allocate funds for employee education and engagement; (4) join a lobbying association for employee-owned businesses, such as the ESOP Association; or (5) make annual contributions to a charity in support of employee ownership, such as the National Center for Employee Ownership. Naturally, planners should tailor such protections, and the overall package of employee benefits under the EOT, to the needs and interests of their clients.

Perpetual employee ownership can be achieved today, without any regulatory or legislative changes, by means of establishing an EOT in a perpetual and purpose trust jurisdiction.

Finally, and of central importance, the EOT is a simple structure. It takes a fraction of the time required to implement an ESOP, and because of the lack of any repurchase obligation or corresponding need for annual valuations, ongoing administration costs for an EOT are minimal. Whereas one of the greatest challenges for ESOP firms is communicating the ESOP's retirement benefits to plan participants, the real-time benefits of an EOT are easy to explain to employee-owners. In turn, the EOT is arguably more efficient as a reward-based feedback mechanism, which is critical when increased productivity is one of the goals of an employee ownership program. At John Lewis Partnership, the rewards are self-apparent, not only in the culture of the company, but at annual meetings where the companywide bonus is declared on a raised placard as a single- or double-digit percentage of salary.

Employee Ownership for the 21st Century

In 2014, the United Kingdom passed new EOT legislation. Thanks to the leadership of Graeme Nuttall at Fieldfisher LLP, author of *The Nuttall Review of Employee Ownership*, British business owners are entitled to a 100% capital gains exemption on the sale of shares to an EOT in the year that the trust achieves majority ownership of the target company. Taxation of Chargeable Gains Act §§ 236(H)–(U). Under British law, trustees must administer shares for the benefit of employees as employees, not as investors. Id. § 236(H). If business conditions require that the target company be liquidated or sold, the trust principal may be donated to charity. Id. §§ 236(K)(2), (L)(5). An EOT is not restricted to majority ownership or a charitable remainder holder, although the capital gains tax exemption is accorded only in the case of majority ownership.

In the United States, serious attention should be dedicated to amending interpretations of the "exclusive benefit" rule that refers to the immediate financial interests of current employees. Congress should reaffirm its original intention for ESOP legislation as a carve-out under ERISA that would "bring[] about stock ownership by all corporate employees" by addressing "regulations and rulings which treat [ESOPs] as conventional retirement plans." Tax Reform Act of 1976, Pub. L. No. 94-455, § 803(h) (1976) (quoted in *Dudenhoeffer*, 134 S. Ct. at 2466). In reviewing ESOP legislation, Congress might consider the evolution of trust law over the past 40 years and provide ESOP founders the option to (1) install perpetual employee ownership as a purpose of an ESOP trust and (2) require ESOP trustees to consider the long-term, financial and nonfinancial interests of current and prospective employees. Finally, Congress might legislate a seamless mechanism for the transition of existing ESOP trusts into perpetual EOTs.

At the same time, business owners can now use an EOT as a practicable alternative to an ESOP that embodies the traditional principles of employee ownership. Likewise, attorneys and trust companies would do well to offer the EOT as a low-cost service option. That said, for many companies, an EOT is not presently a cost-efficient alternative to an ESOP. Notwithstanding lower implementation costs and negligible maintenance costs, EOTs are not able to compare with the substantial tax savings that are available using an ESOP. For this reason, Congress should take action to level the playing field between ESOPs and EOTs. A major step in this direction would be for Congress to (1) qualify EOTs as tax-exempt trusts under IRC § 501(a) (granting EOT companies treatment equivalent to that of ESOP S corporations) and (2) permit capital gains tax deferrals on sales to EOTs under IRC § 1042.

Beyond this federal measure, states should seek to enact incentives for EOTs. New York recently witnessed the introduction of a bill (similar in spirit to the new British law) that allocates a capital gains tax exemption for employee ownership successions that result in majority employee ownership. The bill embraces both EOTs and ESOPs. Assemb. 9618(5), 201st Leg., 238th Sess. (N.Y. 2015). Further, Wisconsin lawmakers are now considering model employee ownership legislation drafted by the author, which includes an array of tax incentives for EOTs, ESOPs, and other forms of employee ownership, in addition to a loan and loan guarantee program, procurement preferences, and a state university-based center.

As the employee ownership community works to expand state and federal incentives for ESOPs, attention should be given to according the same or similar benefits to EOTs and other substantial all-employee ownership plans. In every instance, the primary focus should be on easing the process of employee ownership successions—and thereby broadening access to employee ownership—by means of simple, efficient, and dependable legal mechanisms. ■