The Employee as Investor: The Case for Universal Application of the Federal Securities Laws to Employee Stock Ownership Plans

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NOTES

THE EMPLOYEE AS INVESTOR: THE CASE FOR UNIVERSAL APPLICATION OF THE FEDERAL SECURITIES LAWS TO EMPLOYEE STOCK OWNERSHIP PLANS*

Beginning in the mid-1970s, large numbers of employees became equity investors through widespread corporate adoption of employee stock ownership plans (ESOPs).1 The sudden popularity of this form of worker ownership was not the result of a workers’ revolution, but was instead a response to generous tax subsidies.2 Congress believed that inducing private ESOP formation promised increased productivity and a broadened base of capital ownership in America.3 Whether ESOPs actually have produced the social benefits Congress desired is debatable.4 One certain consequence of the ESOP movement, however, is that a significant percentage of American labor now holds corporate stock.5 ESOPs have bloomed as a result of congressional tax incentives.6 In 1989, approximately

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* The author wishes to thank Professor Jayne W. Barnard for her assistance.
2. See infra note 132 (describing ESOP tax subsidies).
3. See Carlson, supra note 1, at 320-91; infra notes 106, 129-30 and accompanying text.
6. See infra notes 132-35.
one-fourth of all corporate employees in America, roughly ten million workers, participated in over ten thousand ESOPs.7

As a general rule, purchasers of securities are entitled to the protections afforded by the Securities Act of 19338 (1933 Act) and the Securities Exchange Act of 19349 (1934 Act). These protections include mandatory disclosure of financial information necessary to make an informed investment decision, as well as broad remedies entitling investors to redress for any false or misleading statements made in connection with the purchase or sale of any security.10

Congress intended the Securities Acts to be remedial in nature.11 Fraudulent and abusive trading practices of the 1920s, followed by the financial collapse of 1929, formed the principal impetus behind their enactment.12 Rather than regulate the substantive worth of securities being offered to the public, as many states had done, Congress chose to mandate disclosure, and hence liberate investors from ignorance.13 The underlying policy behind the Securities Acts reflects the notion that “[s]unlight is said to be the best of disinfectants; electric light the most efficient policeman.”14

The people most likely to benefit from the disclosure requirements, at least in theory, are those investors for whom the cost of

7. Frederick Ungeheuer, They Own the Place, Time, Feb. 6, 1989, at 50, 50. Corporations that have established ESOPs include Avis, Anheuser-Busch, Delta Airlines, Exxon, GTE, ITT, McDonald’s, J.C. Penney, Proctor & Gamble, Texaco, Unisys, United Technologies, and Xerox. Linda E. Rappaport & John J. Cannon III, Counseling Corporate Clients in the Uses and Implications of Leveraged ESOPs, 663 PRAc. L. INST. CORP. 747, 751 (1989).


9. Id. §§ 78a-78kk.

10. Id. §§ 77e, 77q(a), 78j(b); see infra notes 29-38 and accompanying text.


obtaining information necessary to make efficient and informed investment decisions is prohibitively high. Among participants of ESOPs are an ever-increasing number of blue-collar union employees who are relatively unsophisticated in the intricacies of the financial markets, and who would probably not otherwise own financial securities. Their need for the Securities Acts' protection is therefore compelling.

The question, therefore, is whether employee interests in ESOPs are subject to the regulatory purview of the Securities and Exchange Commission, and, specifically, whether participants' interests in ESOPs are securities within the meaning of the federal securities laws. Although this issue is of relatively recent vintage, the courts that have considered the question are split and inconsistent in both analysis and outcome.

In the recent decision of Uselton v. Commercial Lovelace Motor Freight, Inc., the Tenth Circuit held that an employee stock ownership plan was a security within the meaning of the Securities Act of 1933 and the Securities Exchange Act of 1934, thus rendering the plan subject to the registration and antifraud provisions of the Acts. In reaching this result, the court employed the three-pronged "investment contract" test first used by the Supreme Court in SEC v. W.J Howey Co. The Tenth Circuit's analysis closely tracked, and ostensibly applied, the analysis used in International Brotherhood of Teamsters v. Daniel, in which the Supreme Court held that an involuntary, noncontributory, defined benefit pension plan was not an investment contract and hence was not a security within the meaning of the Securities Acts.

16. See infra notes 239-55 and accompanying text.
17. A 1980 General Accounting Office study concluded that employers frequently overstated the value of stock offered under ESOPs, and performed appraisal valuations that lacked independence or ignored relevant factors. COMPTROLLER GEN., GAO, EMPLOYEE STOCK OWNERSHIP PLANS: WHO BENEFITS MOST IN CLOSELY HELD COMPANIES? 22 (1980).
18. 940 F.2d 564 (10th Cir.), cert. denied, 112 S. Ct. 589 (1991); see infra notes 163-72 and accompanying text.
19. Uselton, 940 F.2d at 585.
20. 328 U.S. 293, 301 (1946); see infra notes 42-46 and accompanying text.
21. 439 U.S. 551 (1979); see infra notes 47-63 and accompanying text.
22. Daniel, 439 U.S. at 558-70.
Other courts that have considered the question of whether interests in employee stock ownership plans are securities have also used the Howey test, as modified and applied in Daniel.23 These courts, however, have reached widely disparate outcomes, often opposite from the result reached in Uselton. In contrast, two courts have refused to apply the Howey-Daniel formulation to resolve this question, relying instead on a literal reading of the Securities Acts.24 The Supreme Court gave explicit support to this textual approach in Landreth Timber Co. v. Landreth.25 Those courts applying this analysis consistently have found that ESOP interests are securities under federal law.

This Note advances the primary thesis that employees who participate in ESOPs are acquiring securities, and are therefore no less entitled to the protections of the Securities Acts and the concomitant benefits of accurate information than are ordinary investors. Moreover, this Note urges universal application of the Securities Acts, as opposed to application of the unpredictable and fact-specific test embodied in the Howey-Daniel formulation. Criticism will focus on two factors that explain why some courts have held that ESOP interests fall outside the definition of a security: the treatment of ESOPs as the functional equivalent of conventional pension plans; and relatedly, misplaced reliance on the Daniel decision.

This Note first reviews the Securities Acts and their underlying policies. It then describes the relevant history of Supreme Court cases regarding the definition of a security and demonstrates the Court’s recent departure from a functional, fact-specific approach to a more literal application of the plain meaning of the Securities Acts. A reconciliation of the two leading Supreme Court cases addressing this issue, Daniel, representing the functional approach, and Landreth, representing the textual approach, will follow. After examining the characteristics of ESOPs and the mechanics of

25. 471 U.S. 681, 693-94 (1984); see infra notes 64-84 and accompanying text.
ESOP transactions, this Note critiques the application of the Howey-Damuel formulation to ESOPs. This critique compares cases that utilized the Howey-Damuel criteria to those cases that applied the textual approach. This Note concludes that the Howey-Damuel formulation or functional test is an inappropriate analytical device for determining whether ESOPs are subject to the 1933 and 1934 Acts. A literal application of the Securities Acts better serves their broad remedial purpose and best protects employees who invest in their employer's stock.

A review of other related issues, namely the acute need for investor protection in the ESOP context and potential ERISA preemption, concludes that concurrent ERISA regulation should present no bar to application of the Securities Acts. Finally, this Note addresses an issue that is essential to application of the Securities Acts to ESOPs: if an ESOP interest is a security, does an "offer to sell" or "sale" of a security "for value" take place, as required by the Acts? Special difficulties as to the offer or sale issue arise in the context of ESOPs resulting from collective bargaining agreements. This Note concludes that a sale or offer for value does indeed occur in this context, particularly with respect to the 1933 Act's registration and antifraud requirements.

THE 1933 AND 1934 SECURITIES ACTS

For the Securities Acts to apply, the following must be shown: the existence of a security;26 under the 1933 Act, a sale for value or an offer to sell for value;27 and, under the 1934 Act, the sale of a security28 If an instrument is in fact a security, and its issuer contemplates an offer to sell for value, its issuer must comply with the registration requirements of the 1933 Act and is subject to the antifraud provisions of that Act.29 If a sale of a security has occurred,

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27. Id. § 77b(3). "The term 'sale' or 'sell' shall include every contract of sale or disposition of a security or interest in a security, for value. The term 'offer to sell' shall include every attempt or offer to dispose of a security or interest in a security, for value." Id.
28. Id. § 78b(14). "The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of." Id. The "for value" requirement is conspicuously absent from the 1934 Act. For the possible significance of this omission, see infra note 292.
29. 15 U.S.C. §§ 77e, 77I, 77q. Section 5(c) of the 1933 Act even prohibits the offer of an unregistered security.
the continuing disclosure requirements and antifraud provisions of the 1934 Act provide private and SEC enforcement remedies.

Although general securities registration entails significant cost, registration of employee benefit plans such as ESOPs requires completion of the less expensive form S-8 registration statement. The registration statement requires the issuer to disclose facts concerning the company's operations, management structure, financial status, existing securities arrangements, and any other information necessary for investors to make informed and intelligent investment decisions. Failing to register a security, or making incomplete, false, or misleading statements in a registration statement or in connection with the offer or sale of a security, potentially will subject the issuer to both criminal and civil penalties.

The 1933 Act contains general antifraud provisions that prescribe making fraudulent statements in connection with the purchase, sale, or offer of a security. These provisions are not de-
dependent on the registration requirements; they apply to the offer or sale of any security, regardless of whether a particular transaction is exempt from registration.\textsuperscript{37} The 1934 Act imposes on the issuer a duty to provide continuing disclosure and subjects the issuer to potential antifraud liability for any untrue statement or omission of material fact in connection with the purchase or sale of a security \textsuperscript{38}

The 1933 and 1934 Acts define a security by naming various instruments.\textsuperscript{39} Because of the remedial nature of the Securities Acts and the almost unlimited capacity of human beings to create myriad forms of investment schemes, Congress intended the definition of a security to be "sufficiently broad and [in] general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security."\textsuperscript{40}

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\item Id. See generally HAZEN, supra note 12, § 7.5-.6 (discussing 1933 Act antifraud provisions).
\item 15 U.S.C. § 78j(b); see also SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1990) (stating that the use of deception in securities exchanges is unlawful); HAZEN, supra note 12, §§ 9.3, 13.1-.2 (discussing 1934 Act continuous reporting requirements and antifraud provisions).
\item See 15 U.S.C. §§ 77b(1), 78c(a)(10).

Unless the context otherwise requires, \textit{the term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, transferable share, investment contract, voting trust certificate, certificate of deposit for a security, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.}

\textit{Id.} § 77b(1). The Supreme Court consistently has held that the two definitions of security contained in the 1933 and 1934 Acts are essentially the same, despite minor differences. See, e.g., Reves v. Ernst & Young, 494 U.S. 56, 61 n.1 (1990).

\item H.R. Rpt. No. 85, 73d Cong., 1st Sess. 11 (1933); see also Reves, 494 U.S. at 60 (recognizing that "Congress painted with a broad brush" when it drafted the definitional provisions of the Acts). The Supreme Court has held that "remedial legislation should be construed broadly to effectuate its purposes. The Securities Exchange Act quite clearly falls into the category of remedial legislation," Tcherepnin v. Knight, 389 U.S. 332, 336 (1967), and "Congress did not intend to adopt a narrow or restrictive concept of security in defining that term." \textit{Id.} at 338.
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The Definition of "Security"

Since the inception of the Securities Acts, courts and commentators have struggled to define the term "security." The Supreme Court has entered the definitional fray on numerous occasions. Examination of these decisions reveals the evolution of the Court's analytical process, from a fact-specific analysis to a more predictable and consistent approach.

The Howey Test

The Supreme Court, in *SEC v. W.J. Howey Co.*, provided the seminal Howey—"investment contract"—test. The Court held that an offering of units of a citrus grove development coupled with a contract for cultivating, marketing, and remitting the proceeds of the harvest is a security within the meaning of the Acts. More specifically, the Court deemed the interest an "investment contract." Essentially, the Howey formulation uses a three-prong test to determine whether an instrument qualifies as an investment contract, thus subjecting it to the Acts: first, whether the instrument involves an investment of money; second, whether it is an investment in a common enterprise; and third, whether there is a reasonable expectation of profits to be derived from the managerial or entrepreneurial efforts of others.


42. 328 U.S. 293 (1946).
43. Id. at 298-99.
44. Id. at 299-301.
45. Id. at 297. Section 2(1) of the 1933 Act and section 3(a)(10) of the 1934 Act include the term "investment contract." 15 U.S.C. § 77b(1), 78c(a)(10) (1988); see supra note 39.
Pension Plans as Securities

The Court considered the definitional status of an employee benefit pension plan in *International Brotherhood of Teamsters v. Daniel*. The Court applied the functional *Howey* test. The Court's analysis in *Daniel* became the touchstone for determining whether pension plans are subject to the Securities Acts.

In *Daniel*, a local chapter of the Teamsters union collectively bargained with plaintiff's employer, a Chicago trucking firm, to produce a defined benefit pension plan for employees represented by the union. The plan was "involuntary," meaning all union members had to accept the plan as a condition of employment if a majority of employees voted to participate in it, and "noncontributory," meaning the employees paid nothing to the plan on an individual basis, although they did relinquish an unspecified amount of higher wages. After the plan administrator refused to provide retirement benefits to the plaintiff, the plaintiff brought suit alleging fraud in connection with the sale of a security in violation of the 1933 and 1934 Acts.

The Court used the *Howey* test to resolve the issue, observing that the test "embodies the essential attributes that run through all of the Court's decisions defining a security." The Court's ap-
plication of the *Howey* test was fact-specific, hinging on the involuntary and noncontributory nature of the plan.\(^{54}\)

Because the plaintiff had made a decision only to become employed, rather than to give up "some tangible and definable consideration in return for an interest that had substantially the characteristics of a security,"\(^{55}\) the interest failed the first "investment" prong of the test.\(^{56}\) The Court stated that the investment that did take place constituted only a "relatively insignificant part of an employee's total and indivisible compensation package."\(^{57}\) The Court rejected the argument that the plaintiff's labor constituted adequate consideration for an "investment" to take place:

> Only in the most abstract sense may it be said that an employee "exchanges" some portion of his labor in return for these possible benefits. He surrenders his labor as a whole, and in return receives a compensation package that is substantially devoid of aspects resembling a security.\(^{58}\)

The pension interest also failed the "expectation of profits" prong. Only one-fifth of the pension plan's income derived from investment profit; the remaining four-fifths derived from employer contributions, with increased contributions used to compensate for shortfalls in earnings.\(^{59}\) Moreover, the realization of plan benefits depended more on the employee's ability to meet the vesting requirements than on the fund's investment success.\(^{60}\) The Court added that application of the Securities Acts to these types of noncontributory, involuntary interests would be superflu-

> "embodies the essential attributes that run through all of the Court's decisions defining a security."


\(^{54}\) *See Daniel*, 439 U.S. at 553 ("This case presents the question of whether a noncontributory, compulsory pension plan constitutes a 'security' (emphasis added)).

\(^{55}\) *Id.* at 560.

\(^{56}\) *Id.*

\(^{57}\) *Id.*

\(^{58}\) *Id.* (footnote omitted). Nevertheless, the Court stated, "This is not to say that a person's 'investment,' in order to meet the definition of an investment contract, must take the form of cash only, rather than of goods and services." *Id.* at 560 n.12 (citing United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 n.16 (1975)).

\(^{59}\) *Id.* at 562.

\(^{60}\) *Id.*
ous due to already existing ERISA regulation. Finally, the Court perceived a lack of congressional intent to subject pension plans to coverage and noted prior SEC inaction.

Notably, the Court omitted any discussion of whether a sale of a security for value occurred. The Court’s discussion of the “investment” prong of the Howey test seems similar to an analysis of the sale issue. However, because the Court held that the plan did not constitute a security, it did not consider the question of whether, if a security had been found, a sale for value took place sufficient to render the transaction subject to the Securities Acts.

**Literal Application of the Securities Acts**

The decision in *Landreth Timber Co. v. Landreth* represents a significant departure from previous definitional cases, which had relied on the Howey test. *Landreth* is important for three reasons: first, the decision presents a literal application of the definitional provisions of the Acts, with the Court utilizing a textual approach; second, the case reveals the Court’s current attitude towards the Howey test; and third, the Court expressed a preference for certainty in the application of the securities laws, for deference to congressional intent as evidenced by a literal reading of the Acts, and for protection of reasonable expectations that the Acts apply to stock.

In *Landreth*, the Court resolved the longstanding controversy of whether the Securities Acts apply to the sale of a controlling block of shares coupled with transfer of active management. A majority of the previous cases had held that the sale of 100% of the stock of a closely held corporation constitutes the sale of a business and hence is not included within the definition of a security. Lower
courts had concluded that because the buyer of the business represents not a passive investor, but an active manager of the purchased business, no commonality of enterprise or significant reliance on the efforts of others exists.\textsuperscript{66} The transaction therefore fails the second and third prongs of the \textit{Howey} test. Such a transaction, courts had held, does not involve an investment contract, and therefore no security exists.\textsuperscript{67}

The Supreme Court in \textit{Landreth} rejected the sale of business doctrine.\textsuperscript{68} Beginning its analysis by noting that "the starting point in every case involving the construction of a statute is the language itself,"\textsuperscript{69} the Court observed that the definitional provisions of the 1933 and 1934 Acts include the term "stock."\textsuperscript{70} Standing alone, however, the fact that the instrument bears the label "stock" is not determinative.\textsuperscript{71} The Court believed that in order for the Acts to apply, the instruments at issue must also possess the traditional characteristics typically associated with stock, such as distribution of dividends, appreciability, and voting rights.\textsuperscript{72} Because the shares

\begin{footnotes}
\item[66.] \textit{Landreth}, 471 U.S. at 684-85.
\item[67.] See infra note 78.
\item[68.] \textit{Landreth}, 471 U.S. at 687-92.
\item[69.] \textit{Id.} at 685 (citing \textit{Blue Chip Stamps} v. \textit{Manor Drug Stores}, 421 U.S. 723, 756 (1975) (Powell, J., concurring)).
\item[70.] \textit{Id.} at 686; see supra note 39.
\item[71.] \textit{Landreth}, 471 U.S. at 686.
\item[72.] \textit{Id.} The characteristics of stock that the Court listed, including "the right to receive dividends contingent upon an apportionment of profits," \textit{id.}, are the same as those it discussed in \textit{United Housing Foundation, Inc.} v. \textit{Forman}, 421 U.S. 837, 851 (1975). In \textit{Forman}, the Court held that nontransferable, nonvoting, and nonappreciable interests in a nonprofit low-income housing cooperative were not securities within the meaning of the Acts, despite the fact that the parties to the transaction called the shares "stock." \textit{Id.} at 856-58. The Court rejected the contention that merely calling the instruments "stock" renders them subject to the Securities Acts. \textit{Id.} at 848. The shares lacked what the Court deemed to be the essential attributes of stock: negotiability, voting rights, dividends, ability to pledge or hypothecate, and appreciability. \textit{Id.} at 851. However, the Court did not completely discount the importance of the name given to the instrument by the parties:

\textit{[W]e do not suggest that the name is wholly irrelevant to the decision whether it is a security. There may be occasions when the use of a traditional name such as "stocks" or "bonds" will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underly-}
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that the plaintiffs had purchased obviously bore these characteristics, the Acts applied to the transaction.\textsuperscript{73}

One impetus behind the Court's textual approach was the notion that parties buying or selling traditional stock reasonably expect the Securities Acts to apply. Because the sale of corporate stock "is typical of the kind of context to which the Acts normally apply, it is much more likely that an investor would believe he was covered by the federal securities laws."\textsuperscript{74} The Court later elaborated on this notion of investor reliance in \textit{Reves v. Ernst & Young}:\textsuperscript{75} "[T]he public perception of common stock as the paradigm of a security suggests that stock, in whatever context it is sold, should be treated as within the ambit of the Acts."\textsuperscript{76}

The most significant aspect of the decision was the Court's refusal to apply the \textit{Howey} test to the sale of a controlling block of stock, a test that the Court, just five years before, had said "embodies the essential attributes that run through all of the Court's decisions defining a security."\textsuperscript{77} Indeed, had the Court applied the

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\item \textsuperscript{73} Id. at 850-51.
\item \textsuperscript{74} \textit{Landreth}, 471 U.S. at 687.
\item \textsuperscript{75} Id. The analysis in \textit{Landreth} parallels the Court's approach in \textit{Tcherepnin v. Knight}, 389 U.S. 332 (1967), in which the Supreme Court considered whether withdrawable capital shares of a savings and loan association were securities and therefore subject to the antifraud provisions of the 1934 Act. \textit{Id.} at 340. In finding that the shares were subject to the Act, the Court did not rest its decision on application of the \textit{Howey} test, stating, "[I]nstruments may be included within any of [the Act's] definitions, as a matter of law, if on their face they answer to the name or description." \textit{Id.} at 339 (citations omitted). The fact that the dividends were contingent upon profits was enough to render the shares "stock." \textit{Id.} The Court further characterized the shares as "certificates of interest or participation in any profit-sharing agreement," \textit{id.}, and as "transferable shares." \textit{Id.}
\item \textsuperscript{76} 494 U.S. 56 (1990).
\item \textsuperscript{77} Id. at 62; see infra note 85. The Court in \textit{Forman} similarly recognized the possibility that the name and attributes of an instrument may induce reliance. See \textit{Forman}, 421 U.S. at 850-51; supra note 72.
\item \textsuperscript{78} International Bd. of Teamsters v. Daniel, 493 U.S. 551, 558 n.11 (1979) (quoting \textit{Forman}, 421 U.S. at 852). In \textit{Landreth}, the Court reasoned around this prior statement by obliquely characterizing it as a "bit of dicta" and by claiming that the statement was made only for "present purposes," and only to explain that the test for "investment contract" might as well be the same as that for an "instrument commonly known as a 'security.'" \textit{Landreth}, 471 U.S. at 691 n.5.
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Howey test, transforming the transaction somehow into an investment contract as defined by that test would have been an almost impossible feat of semantics.\textsuperscript{78}

Instead, the Court circumscribed application of the Howey test. After Landreth, courts may resort to using the Howey criteria only in cases involving unusual instruments that the other specifically enumerated securities listed in the Acts do not describe.\textsuperscript{79} Only then should a court examine the economic reality of the underlying transaction.\textsuperscript{80}

Motivated in part by deference to the perceived congressional intent evidenced by the Acts’ plain meaning, the Court held that the Howey test applies only in determining whether an instrument is an investment contract.\textsuperscript{81} The Court explained that applying the

\textsuperscript{78} See Landreth, 471 U.S. at 697-700 (Stevens, J., dissenting) (arguing that the economic substance of the transaction at issue dictates that it is not subject to the Acts). The transaction fails the commonality component of the test because a single purchaser is buying the entire company. See Canfield v. Rapp & Son, Inc., 654 F.2d 459, 464 (7th Cir. 1981) (“Since [the buyer] purchased all of the stock of [the business], there was no sharing or pooling of funds.”); Chandler v. Kew, Inc., 691 F.2d 443 (10th Cir. 1977). In addition, the purchaser of the shares does not rely on the managerial or entrepreneurial efforts of others if he intends to manage the enterprise himself. See Somogyi v. Butler, 518 F Supp. 970, 984 (D.N.J. 1981); Anchor-Darling Indus. v. Suozzo, 510 F Supp. 659, 663 (E.D. Pa. 1981); see also Robert B. Thompson, The Shrinking Definition of a Security: Why Purchasing All of a Company’s Stock is Not a Federal Security Transaction, 57 N.Y.U. L. Rev. 225, 238-44 (1982) (discussing why the sale of a business fails the Howey test and reviewing cases that have so held).

\textsuperscript{79} Landreth, 471 U.S. at 690.

\textsuperscript{80} Id. The Court stated:

All of the cases on which respondents rely involved unusual instruments not easily characterized as “securities.” Thus, if the Acts were to apply to those cases at all, it would have been because the economic reality underlying the transactions indicated that the instruments were actually of a type that falls within the usual concept of a security. In the case at bar, in contrast, the instrument involved is traditional stock, plainly within the statutory definition. There is no need here, as there was in the prior cases, to look beyond the characteristics of the instrument to determine whether the Acts apply.

\textsuperscript{81} Id. at 691-92.
test to all the other instruments listed in the Acts “would make the Acts’ enumeration of many types of instruments superfluous.”

Disdain for the Howey test is also apparent in the Court’s observation that application of the Howey test in this context would lead to uncertainty. With sales of less than 100% of a company’s stock, or with only limited voting and veto rights transferred, the outcome of application of the Howey test would be largely unpredictable: “We find more daunting the prospect that parties to a transaction may never know they are covered by the Acts until they engage in extended discovery and litigation over a concept as elusive as the passage of control.” The Court eschews the fact-specific nature of the test, and prefers to use a more predictable means of resolving the definitional issue where possible.

82. Id. at 692. Professor Rosin applauds the literal approach the Court took in Landreth as consistent with the doctrine of separation of powers:

[T]he facial approach is rooted firmly in the doctrine of separation of powers of the branches of the federal government. Whether Congress really meant what it said—or even realized the implications of what it said—should not be a matter for the judiciary. The Court should focus on Congress’ actions. The end result of the [Howey] functional approach is that it makes the statutory definition superfluous by substituting a judge-made unitary view of the nature of a security for Congress’ enumeration of a multiplicity of categories.

Rosin, supra note 41, at 361 (footnotes omitted).

83. Landreth, 471 U.S. at 696-97; see also Rosin, supra note 41, at 345.

84. Landreth, 471 U.S. at 696-97. The Court found that the value of certainty outweighed the potential increased federal court workload because more items are now classified as securities. See id. at 696.

In Gould v. Ruefenacht, 471 U.S. 701 (1985), the companion case to Landreth, the Court consistently held that the sale of 50% of the stock of a company is nevertheless a sale of “stock” and hence a transaction within the regulatory purview of the Acts. Id. at 704. The Court once again emphasized the need for certainty. Applicability of the Acts should not turn on vague and fact-specific variables as elusive as the extent of control transferred: “[T]he parties’ inability to determine at the time of the transaction whether the Acts apply neither serves the Acts’ protective purpose nor permits the purchaser to compensate for the added risk of no protection when negotiating the transaction.” Id. at 706.

85. Reves v. Ernst & Young, 494 U.S. 56 (1990), the Court’s most recent excursion into the issue of what is the definition of a security, considered whether demand promissory notes are securities and thus subject to the 1934 Act’s antifraud requirements. The Court explained that the literal approach of Landreth could not be so readily adopted to the sale of notes as it could with stock—even though “notes” are listed in the Acts’ definitional provisions—because the term “note” “may now be viewed as a relatively broad term that encompasses instruments with widely varying characteristics, depending on whether issued in a consumer context, as commercial paper, or in some other investment context.” Id. at 62 (citation omitted). However, the Court refused to apply the Howey test, stating that its use is authorized only for determining whether an instrument is an “investment contract.” Id.
Landreth indicates that the Howey test no longer constitutes the quintessential definition of a security. The Howey test only determines whether an instrument qualifies as an investment contract. A court must first examine the instrument and its characteristics to determine whether it falls within one of the other specific categories listed in the definitional sections of the Acts. If it does, a court must end its inquiry. Only if it cannot readily characterize the instrument should a court examine the economic substance of the transaction, perhaps by way of the Howey criteria. This analytical approach furthers the Supreme Court's endorsement of deference to congressional intent, certainty in securities transactions, and protection of reasonable expectations.

With these principles in mind, the Daniel decision warrants reexamination in light of Landreth. In Daniel, the Court confronted an interest in a defined benefit pension plan and applied the Howey criteria to determine whether the plan qualified as an investment contract. Landreth instructs that the test in Daniel applied only because the case involved "unusual instruments not easily characterized as 'securities.'" Because the pension interest in Daniel did not fall readily into any of the definitional categories at 64. The Court thus continued to relegate the Howey test to a very limited definitional role.

Instead, the Court adopted the four-pronged "family resemblance" test to determine whether notes are securities. Id. at 64-67. That the Court extolled the virtues of consistency and predictability by merely exchanging one fact-specific test for another seems incongruous. However, the widely disparate characteristics of notes and their myriad uses results in some inevitable uncertainty in resolving the definitional status of a particular note. Id. The term "note" may indicate routine consumer financing, short-term debt secured by accounts receivable, or true investment vehicles. Id. Moreover, the "family resemblance" test as adopted begins with the rebuttable presumption that every note is a security. Id. Although this presumption perhaps does little to lend actual certainty by itself, it is at least evidence of the Court's continued emphasis on the objective of applying the Securities Acts in as consistent and as predictable a manner as possible.

86. Or in the case of notes, by way of the "family resemblance" test. Id. at 65.
88. Landreth, 471 U.S. at 690. Of course, the Court applied the Howey test in Daniel because the test contained "the essential attributes that run through all of the Court's decisions defining a security." Daniel, 439 U.S. at 558 n.11. Now, however, the Howey test should be used only to determine whether an interest is an "investment contract." See Reves, 494 U.S. at 64; Landreth, 471 U.S. at 691; supra notes 79-85 and accompanying text.
listed in the Acts, the Court applied the Howey test to determine whether the pension interest was an investment contract.89

The Court in Daniel possibly could have characterized the pension interest as an item enumerated in the Acts. Specifically, the interest could have been a “certificate of interest or participation in any profit-sharing agreement,” as Daniel himself attempted to argue.90 After all, the Court in Tcherepnin v. Knight91 relied on this language in the 1934 Act to find capital shares to be securities.92

A pension interest, however, is an income-deferral arrangement.93 The primary purpose of a pension plan is to provide a

89. See supra notes 53-60 and accompanying text.
90. Daniel, 439 U.S. at 558 n.11. The Court refuted this contention, essentially by stating that if the interest is not an investment contract, it is not a “certificate of interest in any profit-sharing agreement.” Id. The Howey test, in the Daniel Court’s view, applied to both types of instruments. Id., see supra note 53. At least two courts, relying on this language, have followed the same reasoning. See Foltz v. U.S. News & World Report, Inc., 627 F. Supp. 1143, 1157 (D.D.C. 1986); Tanuggi v. Grolier, 471 F Supp. 1209, 1213 n.5 (S.D.N.Y. 1979) (“In the context of a pension plan, the terms ‘investment contract’ and ‘certificate of interest’ have substantially the same meaning.” (citing Daniel, 439 U.S. at 558 n.11)). The Court now rejects universal application of the Howey test. Reves, 494 U.S. at 64; Landreth, 471 U.S. at 692. However, for the reasons discussed here, an interest in a pension plan cannot be characterized as a “certificate of interest in any profit-sharing agreement” under the literal approach either.

92. Id. at 339; see supra note 74.

Realistically, employees view future pension benefits as deferred income which is conditioned on their efforts to meet the plan’s vesting requirements. For example, when faced with a decision to change employers, an employee factors pension benefits into his job choice. He faces the possible loss of future pension benefits upon leaving his former employer, and weighs this loss against the benefits provided by his new employer.

Id. at 1236 (footnotes omitted).
source of secure income to employees after retirement. The retirement payments from a defined benefit pension plan come largely from employer contributions. The plan's investment income serves merely to determine the amount of these employer contributions. The employer is required to increase contributions to cover any shortfalls in plan earnings. The pension interest in Daniel, therefore, was not a meaningful interest in a "profit-sharing agreement" as the plaintiff argued; the plan participant expected to receive deferred compensation derived primarily from employer contributions, not from profits.

For the same reason, an interest in a defined benefit pension plan fails to qualify as an investment contract. The Court in Daniel held that the pension interest failed the Howey test because the plan's income came primarily from employer contributions and because the realization of benefits depended on meeting the plan's eligibility requirements, rather than on the plan's profitability.

Admittedly, the Court in Daniel also found that the pension interest at issue failed the "investment of money" prong of the Howey test because the interest in the plan was involuntary and

94. ERISA itself was enacted to make pension plans "fairer and more effective in providing retirement income for employees" H.R. Rep. No. 807, 93d Cong., 2d Sess. 1 (1974).

95. A pension plan may also be a defined contribution plan, which provides separate accounts for each participant. Payable benefits are dependent on the value of that account at the time of payment. In contrast, a defined benefit plan pays benefits that are fixed or determinable; employer contributions vary in order to meet defined benefit requirements. Participants in defined benefit plans can count on receiving a predetermined level of benefits regardless of the plan's investment performance. Participants in defined contribution plans bear the risk of a reduction in value of the plan's assets because the employer's contributions to the plan are fixed. See Richard D. Brown, Understanding ERISA: An Introduction to Basic Employee Benefits—Pension and Profit Sharing Plans Distinguished, 302 PRACT. L. INST. TAX 99, 113 (1990).

96. See Marilyn J. W. Ford, The Aftermath of Daniel: Private Pension Plans, ERISA, and the Federal Antifraud Provisions, 46 Mo. L. Rev. 51, 64 (1981). With a defined benefit plan, benefits are received independent of market fluctuations; otherwise, the purpose of the plan to provide future income security would be frustrated. Id. at 64-65. Although defined contribution plans are also designed to provide for retirement, they do not afford the same guarantee of definite payments and are riskier. Id. at 65.


98. See supra notes 59-60 and accompanying text.

APPLICATION OF SECURITIES LAWS TO ESOPS

However, even if a plan is voluntary and noncontributory, such that an investment decision does take place under the Howey test, an interest in the typical pension plan still would not be a security. According to lower court decisions subsequent to Daniel, the fact that an interest in a defined benefit plan lacks investment risk is sufficient in itself to place it outside the scope of the Acts. For pension plans, the definitional issue therefore does not turn primarily on whether the plan is voluntary or involuntary, or contributory or noncontributory. The critical factor is whether the instrument possesses the usual investment characteristics of a security as embodied in the “expectation of profits” prong of the Howey test.

Under the principles the Court enunciated in Landreth, courts should now properly understand Daniel as having applied the Howey test only because the interest in the pension plan at issue did not fall neatly into the category of a “certificate of interest or participation in any profit-sharing agreement” or any other enumerated instrument. An interest in an employee stock ownership plan, however, differs significantly from the pension interest in Daniel.

100. Id. at 560; see supra notes 55-58 and accompanying text.


ESOPs

An employee stock ownership plan is a tax-qualified employee benefit plan designed to enable employees to acquire stock ownership interests in their employers. ESOPs are variously used as “technique[s] of corporate finance,” as a means of improving employee productivity, and as antitakeover devices. An interest in an employee stock ownership plan is essentially an interest in a pool of employer stock, managed by a trustee for the benefit of

103. See 26 U.S.C. § 401 (1986). If an ESOP meets the requirements of the Internal Revenue Code and ERISA, it is “tax-qualified” and can be the source of various deductions. The Internal Revenue Code of 1986, at Section 4975(e)(7), defines an ESOP as a defined contribution stock bonus plan designed to invest primarily in qualifying employer securities. For a comparison of defined benefit and defined contribution plans, see supra notes 95-96.


107. ESOPs enable companies threatened by takeover to place large blocks of stock in hands perceived to be friendly and sympathetic to management. See Shamrock Holdings, 559 A.2d at 269-72 (characterizing the particular use of a defensive ESOP as fundamentally fair to Polaroid’s shareholders and employees); O’Toole, supra note 5, at 837 n.19. See generally Margaret E. McLean, Employee Stock Ownership Plans and Corporate Takeovers: Restraints on the Use of ESOPs by Corporate Officers and Directors to Avert Hostile Takeovers, 10 Pepp. L. Rev. 731 (1983) (discussing ESOP takeover implications).
employees. A business typically forms a leveraged ESOP, or an ESOP funded with borrowed money, as a way of raising tax-subsidized capital. Although specific ESOP characteristics may vary, the typical leveraged ESOP transaction occurs as follows.

Assume a corporation wishes to raise fifty million dollars for plant and equipment acquisition. It establishes a qualified ESOP trust with a written trust agreement. The ESOP borrows fifty million dollars from a bank and then uses the proceeds of the loan to purchase stock from the sponsoring employer. The ESOP holds the shares in a suspense account as collateral for the loan and each participating employee holds an account in the plan. When the company makes contributions to the ESOP, the ESOP will use those contributions to pay the principal and interest on the loan or to buy additional shares of stock. As either the company or the ESOP pays off the loan, the bank releases the shares held in the suspense account from encumbrance and allocates them to individual accounts. An allocation is based on the ratio of the participant's compensation to the total compensation of all participating employees. Dividend income from the acquired securities is also individually allocated. In addition, participants acquire voting rights when the stock is credited to their accounts.

Depending on the vesting method used, the employee's interest in the ESOP usually vests completely after five years and thereafter becomes nonforfeitable. If a participant's service with the employer terminates, the percentage actually vested remains nonforfeitable, and the participant forfeits any nonvested percentage. Distributions normally occur no later than one year after

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108. Siake, supra note 105, at 372.
109. Id.
110. The following scenario is a composite of examples from Blackiston, supra note 105, at 126, and Luis L. Granados, Employee Stock Ownership Plans: An Analysis of Current Reform Proposals, 14 U. Mich. J.L. Rev. 15, 22-24 (1980), and assumes that the hypothetical employer wishes the plan to be tax qualified.
114. Id. § 411(a)(2). Vesting requirements of a plan may vary and still be tax qualified.
the last day of the plan year in which retirement, disability, or
death occurs.\textsuperscript{116} After vesting, however, an employee may request
an in-service distribution of stock already allocated to that partici-
pant's account.\textsuperscript{117}

For the ESOP to be tax qualified under the Internal Revenue Code, an employee must have the choice of either receiving benefits in cash, based on the fair market value of the stock, or receiving shares of the stock directly.\textsuperscript{118} Plan distributions, however, often take the form of employer stock.\textsuperscript{119}

A participant in a tax-qualified ESOP possesses complete pass-
through voting rights if the employer's securities trade on the pub-
lic markets.\textsuperscript{120} With respect to privately held stock, the plan may
limit voting rights to the right to direct the vote on any merger or consolidation, recapitulation, reclassification, liquidation, or sale of substantially all of the assets of a trade or business.\textsuperscript{121} On all other matters, the ESOP trustee will vote the stock held by the plan. If the plan limits participants' voting rights, however, the finan-
cial institution that lends to an ESOP will not be entitled to the fifty percent interest exclusion.\textsuperscript{122}

\textit{Comparing ESOPs to Conventional Pension Plans}

ERISA describes an ESOP as a defined contribution plan.\textsuperscript{123} The benefits under the plan depend entirely upon the underlying value

\begin{thebibliography}{99}
\bibitem{117}  Id. § 411.
\bibitem{118}  Id. §§ 409(h), 4975(e)(7).
\bibitem{119}  See Siske, \textit{supra} note 105, at 372. A levered ESOP is unlikely to have cash with which to pay the fair market value of the stock and often must make a distribution in stock as a matter of practical necessity. See Michael J. Nassau, \textit{Plans That Invest in Employer Securities: ESOPs, Stock Bonus Plans, and Eligible IRAs}, 302 PRAC. L. INST. TAX. 857, 867 (1990).
\bibitem{120}  26 U.S.C. §§ 409(e), 4975(e)(7). The participant's interest need not vest in order for him to acquire voting rights, as employees may vote stock that is held in the suspense account. Id. § 409(e)(3). Most ESOPs provide for the trustee to vote the unallocated shares in the same proportion as the employees have voted their allocated shares. See O'Toole, \textit{supra} note 5, at 828-29.
\bibitem{121}  26 U.S.C. § 409(e)(3).
\bibitem{122}  Id. § 133(b)(7). Financial institutions which lend funds to a tax-qualified ESOP trust are permitted to exclude 50% of the interest income derived from the loan. See \textit{infra} note 132.
\bibitem{123}  26 U.S.C. § 4975(e)(7); see \textit{supra} notes 103-04.
\end{thebibliography}
of the employer's stock. Unlike defined benefit plans, in which investment performance has little or no effect upon the amount of the benefit to be paid, the entire risk of the plan falls on employee participants. This fact distinguishes ESOPs from conventional defined benefit pension plans in that pensions are compensatory in nature. In contrast, ESOPs are actually speculative investment opportunities for employees.

Although an ESOP does, in a very limited sense, defer compensation until retirement, it primarily provides employees with ownership interests in their employer. The utility of an ESOP in providing for retirement is very limited. Other forms of employee benefit plans are far superior to ESOPs at providing retirement security. As an investment vehicle, ESOPs lack liquidity and asset diversification; they hold only one asset, the employer's stock, for investment. Rather, the purpose of an ESOP is to present em-

124. See supra notes 95-96 and accompanying text.
125. See supra notes 93-94 and accompanying text.
126. Commentators have recognized this distinction. One practitioner has argued that what he terms an "investment securities plan" should not be confused with a "compensatory securities plan." Stanley Keller, Employee Equity Incentive Arrangements, Rev. Sec. & Com. Reg., June 25, 1986, at 156, 156. An investment securities plan is primarily a means of generating operating capital, whereas a compensatory stock plan's purpose is to benefit employees. Id. Keller asserts that participants in investment securities plans should have access to the type of information that the 1933 Act requires to be disclosed. Id.; see also Robert Duke, Employee Stock Option Plans Under the Securities Acts: A Time for Reexamination, 38 Bus. Law. 1429, 1433-34 (1983) (recognizing distinction between employee stock option plans, which are compensatory in nature, and employee stock purchase plans, which are used for investment purposes).


The substitution of an ESOP for compensation the employee would otherwise have been entitled to receive in cash is not likely to produce future compensation for the employee actuarially (or otherwise) equivalent in value to the foregone cash compensation. ... [A]n employee could receive much less than the foregone compensation if the company performs poorly. This risk factor makes the substitution of the ESOP resemble much more the acquisition of an equity interest in a company than an ordinary deferred compensation arrangement.

Id. (emphasis added).

128. See Henry Hansmann, When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy, 99 Yale L.J. 1749, 1799 (1990) (criticizing ESOPs for this very reason); Levin, supra note 4, at 168 (same); see also McLean, supra note 107, at 743. The author lists the disadvantages of ESOPs from the employee's perspective: "1) an ESOP inevitably results in a high concentration of trust assets in the stock of a
ployees with a meaningful opportunity to share in the company's future earnings, to have some voice in corporate governance, and to own capital wealth.\textsuperscript{129} When Congress provided preferential tax treatment to ESOP formation, it did so in order to broaden the base of capital ownership in this country,\textsuperscript{130} not to provide a new, unnecessary, and inadequate source of employee savings. Indications exist that congressional sponsors of ESOPs placed them under the regulatory coverage of ERISA largely for reasons of practical convenience.\textsuperscript{131}

\textit{ESOPs as "Certificates of Interest or Participation in" Stock}

Establishing an ESOP, like floating new issues of stock, is a method of raising capital. Moreover, ESOPs are a relatively cheap method of capital formation, because Congress has provided gener-

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\textsuperscript{129} ESOPs enable employees "to share in the ownership of corporate capital and in the growth and profitability of the employer." S. REP. No. 36, 94th Cong., 1st Sess. 56 (1975).

\textsuperscript{130} Admittedly, companies often establish ESOPs with other goals in mind. A business may form an ESOP as an antitakeover defense or as a means of raising tax-advantaged capital. See supra notes 105-07. These purposes are, of course, not inconsistent with application of the securities laws. Whether a corporation issues stock to raise capital or to deter a takeover attempt, it undertakes a transaction subject to the Securities Acts.

\textsuperscript{131} The legislative record strongly suggests that Congress' primary motivation in establishing the leveraged ESOP program was to alleviate the disparity of wealth distribution in the United States economy. Senator Russell Long, principal supporter and architect of the ESOP program, attacked the high concentration of capital ownership in America: "A continuing fundamental weakness of our system is that so many Americans own so very little while a relative few Americans own a great deal." 129 CONG. REC. 33813 (1983) (statement of Sen. Long). The Senator argued that America has only a "scanty sprinkling of capitalists," with highly concentrated holdings in capital wealth. Id. He decried the observation that "[m]ost working Americans owe rather than own [and] accumulate debts rather than assets." Id. at 33817.

\textsuperscript{131} See Employee Ownership on Hostile Takeovers: Hearings on S.1323 Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 4 (1987) (statement of former Sen. Long) (asserting that the reason the ESOP legislation appeared in the tax and pension area was because he served on the Finance Committee; if he were on the Armed Services Committee instead, ESOPs would be tied to government contracts); Granados, supra note 110, at 48-49 (suggesting that the ESOP provisions' position in the tax code is due to Senator Long's chairmanship of the Senate Finance Committee).
ous tax incentives that attend the establishment of ESOPs. If a company needs to raise new capital, it can do so much less expensively by selling stock to employees through the ESOP device, and taking advantage of these various tax subsidies, rather than through a public offering. By allowing companies to use ESOPs as techniques of corporate finance, Congress sought to encourage the formation of ESOPs by employers who otherwise would not create them. Absent these favorable tax incentives to use ESOPs as tools of finance, employers would most likely forego establishing ESOPs on a widespread scale.

In short, an interest in an ESOP amounts to an interest in stock. An ESOP is simply a tax-preferred means by which companies sell stock to employees in order to raise capital. ESOPs are in reality not income-deferral devices, but equity investment vehicles. In sharp contrast to employees who participate in pension plans, those who participate in ESOPs actually become equity investors.

132. In addition to the usual tax advantages of employee benefit plans such as employer contribution deductions, 26 U.S.C. § 404(a) (Supp. II 1990), employee deferral of accumulated income, id. § 409(a), and exemption of the ESOP trust from taxation of earnings, id. § 501(a), (c)(17), an ESOP enjoys other substantial tax incentives not available to other plans. These tax incentives make ESOPs a very attractive means of raising capital. A financial institution lending money to an ESOP may exclude from gross income 50% of the interest received therefrom. 26 U.S.C. § 133. For the institution to receive this partial exclusion, the ESOP must own 50% or more of the stock of the sponsoring employer, id. § 133(b)(6)(A), the term of the loan cannot exceed 15 years, id. § 133(b)(1), and complete voting rights must pass through to all employees. Id. § 133(b)(7). The effect of the 50% exclusion is to reduce the cost of ESOP borrowing, as lenders will presumably pass some of the tax savings on to ESOPs. In addition, a sponsoring employer may deduct any contributions used to repay principal or interest on an ESOP loan, up to 25% of total compensation paid to ESOP participants. Id. § 404(a)(9)(A). Another incentive is that a sponsoring employer may deduct dividends paid on allocated shares, whether paid directly to participants or used to make payments on an ESOP loan. Id. § 404(k). Finally, shareholders may under certain circumstances defer tax on the gain on employer securities sold to an ESOP if they subsequently reinvest the proceeds. Id. § 1042(c)(3), (4). For a more detailed treatment of tax benefits applicable to ESOPs, see David Ackerman, Innovative Uses of Employee Stock Ownership Plans for Private Companies, 2 DePaul Bus. L.J. 227, 233-45 (1980).

A study conducted by the Office of Management and Budget in 1985 estimated that the total cost to the Treasury of ESOP tax subsidies would be $2.5 billion in 1986, increasing to at least $4.4 billion in 1990. John Hoerr, ESOPs: Revolution or Ripoff?, Bus. Wk., Apr. 15, 1985, at 94.


135. Although used and promoted since the 1950s, ESOPs did not become popular until tax subsidies first appeared in 1974. See Hansmann, supra note 128, at 1797.
in a single enterprise, bearing all the usual risks of common stock ownership. ESOPs possess the traditional characteristics associated with stock, including that which the Supreme Court deemed most important in *Tcherepnin v. Knight*\(^\text{136}\) and *United Housing Foundation, Inc. v. Forman:*\(^\text{137}\) the right to receive dividends contingent upon an apportionment of profits.\(^\text{138}\) The vesting of ESOP participants' interests entitles them to receive those shares allocated to their accounts, regardless of whether they continue in the company's employ until retirement. A vested ESOP interest therefore possesses all of the salient characteristics of traditional stock emphasized in *Forman:* voting rights, appreciability, the ability to pledge or hypothecate, and negotiability.\(^\text{139}\) The Securities Acts literally apply to an interest in an employee stock ownership plan as a "certificate of interest or participation in" stock.\(^\text{140}\)

Admittedly, particular vesting requirements of an ESOP may vary, with some plans imposing more stringent preconditions to vesting than others. The chance that an employee might fail to meet vesting requirements should not, however, cloud the issue of whether an interest in an ESOP is a security within the meaning of the Acts. Rather, the possibility of forfeiture relates to the sale issue, not to the security issue. Specifically, conditional vesting raises the issue of whether a sale of a security has taken place when an employee accepts a wage reduction in return for a security—a "certificate of interest or participation in" stock—when complete ownership of the underlying stock is contingent on fulfilling vesting requirements.\(^\text{141}\) For purposes of clarity, however, the two analyses should remain distinct.

Properly understood, an ESOP is simply a vehicle through which an employer sells stock to employees. A court need not resort to the *Howey-Daniel* test in order to resolve the definitional question. As the Supreme Court held in *Reves,* "the public perception of common stock as the paradigm of a security suggests that stock, in *whatever context it is sold,* should be treated as within the ambit

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138. *Tcherepnin,* 389 U.S. at 339; see supra notes 72, 74 and accompanying text.
139. *Forman,* 421 U.S. at 851; see supra note 72 and accompanying text.
141. See infra notes 313-19 and accompanying text.
of the Acts."\textsuperscript{142} That the tax laws label ESOPs "pension plans" should not disguise their true nature.\textsuperscript{143}

**CASE LAW TREATMENT OF THE DEFINITIONAL STATUS OF ESOPs**

Five cases have considered the definitional status of ESOPs. Two utilized the *Howey-Daniel* test with conflicting outcomes: *Childers v. Northwest Airlines, Inc.*\textsuperscript{144} and *Uselton v. Commercial Lovelace Motor Freight.*\textsuperscript{145} Both cases arose after *Landreth Timber Co. v. Landreth.*\textsuperscript{146} One pre-*Landreth* case, *Bauman v. Bish,*\textsuperscript{147} did not refer to the *Howey-Daniel* criteria explicitly, but relied on *International Brotherhood of Teamsters v. Daniel*\textsuperscript{148} in holding that no sale had taken place with respect to ESOP interests.\textsuperscript{149}

*Hood v. Smith's Transfer Corp.*\textsuperscript{150} and *Harris v. Republic Airlines, Inc.*,\textsuperscript{151} serve as a basis for comparison, representing the best method of analyzing whether ESOPs are securities within the meaning of the Acts.

**Cases Applying Howey-Daniel Analysis**

In *Childers v. Northwest Airlines, Inc.*,\textsuperscript{152} the plaintiffs, members of a union, had agreed to a fifteen percent wage reduction in exchange for an interest in an ESOP.\textsuperscript{153} A few years after reaching a collective bargaining agreement, the employer refused the plaintiffs their benefits because promotions supposedly rendered them

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\textsuperscript{142} Reves v. Ernst & Young, 494 U.S. 56, 62 (1990) (emphasis added) (citing Landreth Timber Co. v. Landreth, 471 U.S. 681, 693 (1984)).

\textsuperscript{143} See Granados, supra note 110, at 49 ("[T]he ESOP is not and was never intended to be primarily a tax gimmick. The ESOP is much more than that—it is a way of restructuring the system of capital credit . . . .")

\textsuperscript{144} 688 F. Supp. 1357 (D. Minn. 1988).

\textsuperscript{145} 940 F.2d 564 (10th Cir.), cert. denied, 112 S. Ct. 589 (1991).

\textsuperscript{146} 471 U.S. 681 (1984).

\textsuperscript{147} 571 F. Supp. at 1063.

\textsuperscript{148} 439 U.S. 551 (1979).

\textsuperscript{149} *Bauman*, 571 F. Supp. at 1063.

\textsuperscript{150} 762 F. Supp. 1274 (W.D. Ky. 1991).


\textsuperscript{152} 688 F. Supp. 1357 (D. Minn. 1988).

\textsuperscript{153} Id. at 1359.
ineligible to participate in the plan.\textsuperscript{154} The plaintiffs alleged a violation of the antifraud provisions of the 1934 Act.\textsuperscript{155}

Without discussing the differences between ESOPs and pension plans, and without referring to Landreth, the district court analyzed the issue by comparing the ESOP to the pension plan in Daniel and consequently applied the Howey-Daniel test.\textsuperscript{156} The court found that participation in the plan was compulsory because the union put the issue to a majority vote.\textsuperscript{157} Thus, the "collective bargaining agreements bound all union members regardless of whether they supported the [wage-ESOP swap],"\textsuperscript{158} and so the plan failed the investment prong of the test. The plan also failed the expectation of profits prong\textsuperscript{159} because, in the court's view, the participants did not expect profits from the efforts of the fund's managers:\textsuperscript{160} "The ESOPs were funded only with Republic stock, which the ESOPs' managers were not free to trade. Thus, any appreciation in the value of the stock would not be attributable to the management of the ESOPs but to the financial recovery of Republic as a whole."\textsuperscript{161} The court also believed that the ESOPs represented a method of deferring income, and "not a method of reducing wages to pay for stock."\textsuperscript{162}

With analogous facts, the Tenth Circuit reached the opposite conclusion in \textit{Uselton v. Commercial Lovelace Motor Freight.}\textsuperscript{163} The plaintiff-employees agreed to a seventeen percent reduction in wages due under the union's collective bargaining agreement in exchange for an interest in a leveraged ESOP.\textsuperscript{164} Instead of collectively participating, all of the union members individually elected to participate in the plan.\textsuperscript{165} The district court found that the in-

\textsuperscript{154} Id.

\textsuperscript{155} Id. at 1362.

\textsuperscript{156} Id. at 1363. The court began its analysis with the observation, "[T]he list of numerous examples in the statutory definition does not include ESOPs." Id. at 1362.

\textsuperscript{157} Id.

\textsuperscript{158} Id.; see also \textit{supra} note 55 and accompanying text.

\textsuperscript{159} Childers, 688 F. Supp. at 1363; see \textit{supra} note 59 and accompanying text.

\textsuperscript{160} Childers, 688 F. Supp. at 1363.

\textsuperscript{161} Id.

\textsuperscript{162} Id.


\textsuperscript{164} Id. at 570.

\textsuperscript{165} Id.
terests in the plan were not investment contracts and dismissed
the plaintiffs' securities fraud claims. The court of appeals, al-
though also applying the Howey-Daniel test, reversed the
decision.

Unlike the district court in Childers, the Tenth Circuit found
wage reductions sufficiently contributory to pass muster under the
investment prong of the test. In addition, the court found the
plan voluntary because "each such employee had the option of ei-
ther accepting [Commercial Lovelace's] wage reduction program or
of continuing employment under the terms of the existing union
contract." Had the employer required that employees vote col-
lectively to participate in the plan, as the company in Childers had
done, the plan would not have been voluntary under the Howey-
Daniel test.

The Court of Appeals for the Tenth Circuit also contradicted the
district court in Childers in its application of the third prong, wheth-
whether participants expected profits from the efforts of others.
The court wrote:

Both of these requirements [expected profits and efforts of
others] are met in this case because any profit on plaintiffs' ESOP interest would occur through dividend distributions and
appreciation in the value of stock allocated to their accounts,
which in both cases would result primarily from the efforts of
CL's managers and its employees . . . . This fact distinguishes
the CL ESOP from other voluntary, contributory employee ben-
efit plans that have failed this final prong of the Howey test.

Because the ESOP satisfied all three prongs of the Howey test, the
court deemed the ESOP interests investment contracts and, there-
fore, subject to the Acts.

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166. Id. at 571.
167. Id. at 573. The court of appeals indicated, however, that it might have found the Securities Acts applicable under the literal approach had the parties addressed the issue on appeal. Id. at 575 n.4.
168. Id. at 575. "[T]he transaction . . . required plaintiffs and Lee Way's other union employees to surrender a portion of the wages due them under a valid collective bargaining agreement in exchange for an interest in the [Commercial Lovelace] ESOP . . . ." Id.
169. Id.
170. Id.
171. Id. at 576-77 (citations omitted).
172. Id. at 573-84.
Bauman v. Bish\textsuperscript{173} concerned the largest ESOP in existence at the time.\textsuperscript{174} The plaintiffs sought to force their employer to register the ESOP with the SEC and to disclose material information, pursuant to the 1933 Act, \textit{before} they collectively agreed to participate in the plan.\textsuperscript{175} They also claimed damages for alleged material omissions connected with a solicitation to purchase stock that violated the antifraud provisions of the 1933 Act.\textsuperscript{176} Under the proposed deal, the employer would have required its employees to accept reductions in wages in return for interests in a leveraged ESOP.\textsuperscript{177}

The district court first labelled the ESOP a noncontributory, involuntary pension plan without explaining what factors rendered the plan involuntary.\textsuperscript{178} In addition, the court believed that the proposed ESOP was primarily a method of deferring income.\textsuperscript{179} It did recognize, however, that an ESOP is not the functional equivalent of a regular pension plan; therefore, "the \textit{Daniel} decision, while providing guidance on the issue, [was] not viewed as dispositive."\textsuperscript{180}

The court instead relied on \textit{Daniel}, not to determine whether the ESOP was an investment contract, but to determine whether a sale for value would have taken place via the investment prong of the \textit{Howey} test.\textsuperscript{181} The court found the ESOP interest was involuntary, despite the fact that the plaintiffs had sued in order to decide whether to vote to participate in the plan. Further, the court held the ESOP interest to be noncontributory, despite the specific percentage wage reduction. Based on these two conclusions, no sale of a security for value would have occurred.\textsuperscript{182} The court did not even

\begin{footnotes}
\item[174] Id. at 1056.
\item[175] Id. at 1057, 1062. Offering to sell a security absent registration with the SEC is unlawful. 15 U.S.C. § 77e(c) (1988); see supra note 29.
\item[176] Bauman, 571 F. Supp. at 1062.
\item[177] Id. at 1057.
\item[178] Id. at 1063.
\item[179] Id. at 1064.
\item[180] Id. at 1063.
\item[181] Id. at 1064.
\item[182] Id.
\end{footnotes}
consider the more fundamental question of whether the ESOP interest at issue qualified as a security.\textsuperscript{183}

\textit{Critique of the Howey-Daniel Approach}

These cases reveal the deficiencies of the \textit{Howey-Daniel} test as applied to ESOPs. Application of the \textit{Howey-Daniel} criteria to interests in ESOPs does not comport with congressional intent, inevitably results in uncertainty and unpredictability, fails to protect employees' expectations, and is contrary to \textit{Landreth Timber Co. v. Landreth}.\textsuperscript{184}

Specific wage reductions in exchange for participation in ESOPs confronted all three courts, yet the courts reached conflicting results. The courts in \textit{Childers} and \textit{Bauman} found specific wage reductions noncontributory, whereas the court in \textit{Uselton} found the plan contributory. The approach in \textit{Uselton} is more defensible, but arguably it is inconsistent with \textit{Daniel}.\textsuperscript{185}

Under the investment prong of the \textit{Howey-Daniel} test, the court in \textit{Childers} found participation involuntary despite the fact that a majority of union members affirmatively voted to participate in the plan.\textsuperscript{186} Although consistent with \textit{Daniel}, the court's reasoning is problematic. The opinion does not reveal the exact percentage of members who voted to participate in the ESOP, but the court's analysis, if extended to what must be its logical conclusion, would indicate that if all members had unanimously voted to participate, then the plan would have been sufficiently voluntary. Somewhere between bare majority and unanimous approval lies the demarca-

\textsuperscript{183} The court also relied on \textit{Daniel} for the proposition that ERISA takes the ESOP interest out of the regulatory purview of the Acts. \textit{Id.} at 1064-65.
\textsuperscript{185} The plaintiff in \textit{Daniel} had voted on a collective bargaining agreement that chose employer contributions to the pension fund in lieu of receiving other wages or benefits. \textit{International Bhd. of Teamsters v. Daniel}, 439 U.S. 551, 557 (1979). The plaintiff in \textit{Daniel} therefore had relinquished higher wages, albeit an undefined percentage, in exchange for a pension interest. The Court nevertheless held that \textit{Daniel} made no payment into the fund sufficient to find an investment. See supra notes 51-58 and accompanying text. That the wage reduction in \textit{Uselton} was specifically expressed in percentage form is arguably an irrelevant distinction under the first prong of the investment contract test.
\textsuperscript{186} \textit{Childers v. Northwest Airlines, Inc.}, 688 F. Supp. 1357, 1363 (D. Minn. 1988) ("[C]ollective bargaining agreements bound all union members regardless of whether they supported the [wage-ESOP swap].").
tion between voluntary and involuntary; exactly where is left to a case-by-case determination. Application of the Securities Acts should not depend on the relative strength of a voting majority, because this variable is as elusive as the extent of control transferred in the sale of a business. Because of its inherent uncertainty, use of the Howey-Daniel test should be avoided if the Securities Acts are capable of literal application.

In Bauman, the court used the investment prong of the Howey-Daniel test to determine whether a sale had taken place, not to determine whether a security existed. This approach finds no support in Daniel. The Supreme Court in Daniel never considered the issue of whether a sale or an offer of sale of a security had occurred within the meaning of the 1933 and 1934 Acts because it never found the existence of a security in the first place. This approach, moreover, is plagued with the same deficiencies associated with voluntariness, a concept which, resting on unworkable distinctions between voluntary and involuntary, is too elusive to afford meaningful predictive value in the context of collectively bargained-for ESOPs.

Using the investment prong of the Howey-Daniel test to ascertain the existence of a sale also ignores the fact that the 1933 Act's registration requirements are triggered merely upon an offer of securities; a completed sale is not a prerequisite. The court in Bauman apparently overlooked or ignored this facet of the 1933 Act, focusing instead on whether the employees would have purchased a security when participation was to be put to a collective

187. See Baeza & Taylor, supra note 127, at 708. Where it may make some sense to find "individualized" decisions lacking where only 51% of a bargaining unit votes in favor of a collective bargaining agreement that includes a trade-off and the ESOP/wage reduction arrangement is "involuntarily" imposed on the other 49%, the question is a much closer one where an employer announces that such a plan will only be implemented if 85 or 90 percent of the employees vote in favor of it. Courts' future receptivity to arguments based on collective decision making may well depend heavily on the facts and circumstances of particular cases.

Id. (emphasis added).

188. See supra notes 83-84 and accompanying text.


190. International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 556 n.8 (1979); see supra note 63 and accompanying text.

191. See supra note 29.
The collective decision to invest in the ESOP, however, which the court characterized as involuntary, is subsequent to the employer's offer of the ESOP and is therefore irrelevant to application of the 1933 Act.

The courts also applied, with equal inconsistency, the expectation of profits prong of the test. *Childers* and *Uselton* came to opposite conclusions on virtually identical facts. The court's analysis in *Childers* is also puzzling. The court held that because any expectation of profits would derive not from the management of the ESOP, but from appreciation of the stock, no expectation of profits from the efforts of others resulted. Apparently, the court believed that to satisfy the test, either the term "others" had to mean only the ESOP's fund managers, or that stock appreciation in and of itself is not sufficient profit.

The court in *Uselton* found that the ESOP in question satisfied the expectation of profits prong of the test. Nevertheless, the court carefully confined its holding to the narrow facts of the case, apparently implying that not all ESOPs will qualify as investment contracts: "Depending on the specific terms of the plan, therefore, some voluntary, contributory employee interests will not qualify as investment contracts under the *Howey* test." This ambiguity is precisely why the *Howey-Daniel* test is inappropriate in this context. A case-specific approach means that "coverage by the Acts would in most cases be unknown and unknowable to the parties at the time the stock was sold." Application of the *Howey* test to ESOPs results in the same uncertainty and unpredictability that the Supreme Court in *Landreth* sought to avoid.

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193. Id. at 1063.
194. See infra notes 292-319 and accompanying text (discussing a superior method of analyzing the sale or offer issue).
197. Uselton, 940 F.2d at 570.
198. Id. at 584 n.23.
Both Childers and Bauman characterized the particular ESOPs at issue as a means of deferring income.\(^2\) This view ignores the nature, reality, and the primary purpose of ESOPs—employee capital ownership. The only asset in ESOPs, the employer’s stock, is an investment that is far too speculative and risky to be a viable method of income deferral.\(^2\)

Finally, these cases fail to promote congressional intent and contradict Supreme Court precedent.\(^2\) Landreth, and later Reves, demonstrate that an instrument does not have to be an investment contract to be a security;\(^2\) otherwise, Congress’ extensive list of instruments that should always be deemed securities is rendered meaningless. “Stock” and “certificates of interest” in stock are among those instruments listed in the 1933 and 1934 Acts.\(^2\) ESOPs therefore fall within the purview of the Acts by default.

Cases Not Relying on Howey-Daniel to Conclude ESOPs Are Securities

The court in Hood v. Smith’s Transfer Corp.\(^2\) did not use the Howey test to determine whether an ESOP is a security within the meaning of the Acts. The facts of this case are familiar. The plaintiffs had agreed to a fifteen percent wage cut in exchange for interests in an ESOP.\(^2\) Each employee individually elected to participate.\(^2\) In this case, however, the defendant-employer had

\(^2\) See supra notes 127-28 and accompanying text.
\(^2\) Bauman, however, was decided before Landreth.
\(^2\) See supra note 39.
\(^2\) Id. at 1277.
\(^2\) Id. at 1279. Interestingly, the Teamsters Union had refused to recommend or approve the proposed ESOP to its members. Id. The Teamsters Union had been involved in many cases concerning alleged securities fraud in connection with ESOPs and pensions. Id. at 1281. Perhaps this refusal to approve the ESOP was a savvy realization that putting the proposed ESOP to a vote might have rendered the plan involuntary and hence either not an investment under Howey-Daniel or not a sale of a security as per Bauman. See supra notes 152-70, 173-83 and accompanying text.
registered the ESOP with the SEC and issued a prospectus to employees.209 After a merger, the company terminated the ESOP.210 Plaintiffs subsequently filed suit, alleging, *inter alia*, material misstatements in the prospectus regarding the valuation of shares.211 The court refused to apply the *Howey-Daniel* test to resolve the definitional status of the ESOP at issue.212 Citing *Landreth*, the court emphasized that the *Howey* test applies only to determine whether an instrument is an investment contract,213 and applies only when the interest at issue does not fit within one of the instruments listed in the Acts.214 Otherwise, universal application of the *Howey* test would render the specific enumeration of instruments in the Acts superfluous.215 The court correctly characterized the interests in the ESOP as simply interests in stock, and hence literally subject to the Acts:

Participants in Smith’s ESOP acquired shares of common stock. Stock is one of the kinds of securities specifically enumerated in the statutory definition. Unlike the *Daniel* plaintiffs, plaintiffs here make no claim concerning any interest in an investment contract, and the *Howey* test is simply inapplicable. . . . The Smith’s ESOP was simply a device for distributing stock in accordance with plaintiffs’ decisions to make those investments.216

The fact that the participants’ interests possessed the “traditional characteristics of securities—e.g., an assigned par value, the future possibility of dividend payments, the capacity to appreciate, and voting rights”217—also influenced the decision. The defendant’s reliance on *Daniel* was misplaced, the court held, because *Daniel* involved a pension plan; in contrast, an ESOP “does not

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210. *Id.* at 1280.
211. *Id.* at 1281.
212. *Id.* at 1291.
213. *Id.* (citing *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 691 (1984)).
214. *Id.*
215. *Id.*
216. *Id.*
217. *Id.* at 1289. The court also “acknowledge[d] that the ESOP restricted plaintiffs’ ability to negotiate and pledge the shares allocated to them under the ESOP, but conclude[d] that those restrictions are not sufficient to negate the character of plaintiffs’ interests as securities.” *Id.* at 1290 n.22.
have the primary indicia of a pension plan—i.e., the payment of benefits only upon retirement."\(^{218}\)

The opinion also stressed that the parties reasonably expected that the Securities Acts would apply, because the defendants had registered the ESOP with the SEC.\(^ {219}\) Subsequently to deny the ESOP’s status as a security placed the defendants in an untenable position: "The prospectus prominently and repeatedly refers to ESOP participants’ interests as shares of common stock and as securities."\(^ {220}\)

Although doing so was not necessary to the decision, the court distinguished the ESOP from the pension plan in *Daniel* by characterizing the ESOP interests as voluntary and contributory.\(^ {221}\) It noted that employees had a choice whether to participate and the court deemed payroll deductions direct payments for the purchase of common stock.\(^ {222}\) The court also stated that "[n]either plaintiffs nor [defendant] intended those deductions to be a mere deferral of income."\(^ {223}\)

The court in *Harris v. Republic Airlines, Inc.*\(^ {224}\) also used the *Landreth* plain meaning approach with respect to an ESOP. The plaintiffs had relinquished current pension rights and agreed to a wage cut in exchange for participation in a partnership plan and an ESOP.\(^ {225}\) The employer later reneged on certain promises it made concerning eligibility requirements.\(^ {226}\)

Quoting Judge Friendly’s perceptively simple statement, "[s]tock is indubitably a security within the definitions of the Securities Acts,"\(^ {227}\) *Harris*’ reliance on *Landreth* closely tracked the reasoning used in *Hood*. For example, the court held that the characteristics of the ESOP interest mirrored those of traditional

\(^{218}\) *Id.* at 1290.

\(^{219}\) *Id.* at 1289.

\(^{220}\) *Id.*

\(^{221}\) *Id.* at 1290.

\(^{222}\) *Id.*

\(^{223}\) *Id.* at 1290-91.


\(^{225}\) *Id.* at 98,621-22.

\(^{226}\) *Id.* at 98,622.

\(^{227}\) *Id.* at 98,623 (quoting *Yoder v. Orthomolecular Nutrition Inst., Inc.*, 751 F.2d 555, 558 (2d Cir. 1985)).
stock;\textsuperscript{228} the context in which the transaction took place raised expectations that the Acts would apply;\textsuperscript{229} and, the court was unable to characterize the ESOP as an ordinary pension plan.\textsuperscript{230} The employees were not merely deferring income but "were being asked by management to make a fairly speculative capital investment in the Company. They were not simply being asked to accept the same compensation package in a different—presumably deferred—form."\textsuperscript{231} Finally, the court found Daniel to be inapposite: "The ESOP does not convert this case into an analogue to [International Brotherhood of] Teamsters v. Daniel and it does not insulate the transaction from the reach of federal securities laws."\textsuperscript{232}

The approach of the courts in these cases best serves the values of certainty and deference to congressional intent and more accurately reflects the true nature of ESOPs as securities. In addition, these opinions correctly point out that the context in which these transactions occur raises expectations on the part of employees that they now or later will own stock and that the federal securities laws will protect them. As the Court in Landreth explained: "Instruments that bear both the name and all of the usual characteristics of stock seem to us to be the clearest case for coverage . . . . [T]raditional stock represents to many people, both trained and untrained in business matters, the paradigm of a security."\textsuperscript{233} Landreth explicitly recognized the necessity of protecting expectations that arise when parties deal in stock.\textsuperscript{234}

In soliciting employee participation, companies frequently tout the ownership and profit-sharing aspects of an ESOP. For example, in Harris, the employer offered an ESOP with the accompanying statements: "Each employee is entitled to any dividends on his or her stock and directs how the stock held in his or her account

\textsuperscript{228} Id.
\textsuperscript{229} Id.
\textsuperscript{230} Id. at 98,625.
\textsuperscript{231} Id. at 98,624. The court additionally wrote, "[P]laintiffs therefore did not simply substitute one form of compensation for a different sort of compensation . . . . Instead, these plaintiffs traded compensation for what amounted to an equity interest in the Company. They became investors." Id. at 98,626 (emphasis added).
\textsuperscript{232} Id.
\textsuperscript{234} See supra notes 74-76 and accompanying text.
shall be voted at stockholders' meetings," and "[t]hose who share in the risk also share in any profits." In *Hood*, the employer's prospectus frequently referred to the ESOP interests as stock. Courts should not frustrate workers' reasonable expectations that employers engender with these promotional statements.

**The Need for Investor Protection**

Another argument for extending the application of the Securities Acts to ESOPs without resorting to the *Howey-Daniel* test is the need for investor protection, which a literal approach best serves. The Supreme Court in *Landreth Timber Co. v. Landreth* and *Gould v. Ruefenacht* expressed sensitivity to this concern.

The need for protecting employees' expectations is even stronger in the ESOP context than in the case of the relatively more sophisticated purchaser of a business. More so than almost any other class of investor, employees—particularly blue-collar union members—would benefit from the registration and antifraud provisions of the Acts.

In *SEC v. Ralston-Purina*, the Supreme Court expressly recognized the need for the Acts' protections in the context of employee stock ownership plans. The case dealt with the narrow issue of whether a company's offer of its stock to employees was exempt from registration under the 1933 Act as "not involving any public offering." The Court upheld the SEC's injunction against Ralston-Purina's further sales of its common stock to 417 of its lower-

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236. *Id.* at 98,621.
241. "[T]he parties' inability to determine at the time of the transaction whether the Acts apply neither serves the Acts' protective purpose nor permits the purchaser to compensate for the added risk of no protection when negotiating the transaction." *Gould*, 471 U.S. at 706; see supra note 17.
level workers.\textsuperscript{244} The opinion emphasized that employees are not less entitled to protections under the 1933 Act merely by virtue of their employment relationship.\textsuperscript{245} The Court stated:

\begin{quote}
The focus of the inquiry should be on the need of the offerees for the protections afforded by registration. The employees here were not shown to have access to the kind of information which registration would disclose. The obvious opportunities for pressure and imposition make it advisable that they be entitled to compliance with registration.\textsuperscript{246}
\end{quote}

The need for investor protection is especially strong in the context of employee stock ownership plans. Corporations do not always establish ESOPs with the best interests of employees in mind. They often utilize ESOPs as a means of entrenching current management in order to ward off potential takeovers.\textsuperscript{247} The potential for abusive and fraudulent behavior is clear.

ESOPs are most frequently formed in labor-intensive companies.\textsuperscript{248} Employees who participate in ESOPs are typically blue-collar union members who are relatively unsophisticated in the vagaries of securities and financial markets.\textsuperscript{249} The information that

\begin{footnotesize}
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\item \textsuperscript{244} Id. at 121.
\item \textsuperscript{245} Id. at 126.
\item \textsuperscript{246} Id. at 127 (emphasis added). The Court cited a House Report explaining the reasons for the rejection of a 1934 amendment that would have exempted employee stock offerings from the Acts: “[P]articipants in employees’ stock-investment plans may be in as great need of the protection afforded by the availability of information concerning the issuer for which they work as are most other members of the public.” Id. at 126 (citing H.R. Rep. No. 1838, 73d Cong., 2d Sess. 41 (1934)).
\item \textsuperscript{247} See McLean, supra note 107, at 766. Professor McLean writes:

An ESOP is a valuable corporate device which confers benefits upon the employees and the corporation. . . . However, the potential benefit to the corporation offered by the use of an ESOP as a corporate takeover defense tool should be deterred. In light of ERISA and recent court decisions, the scope and establishment of an ESOP should be limited to its intended purpose—an employee benefit plan—not a weapon in the high power arena of corporate takeovers.

Id.
\end{itemize}
\end{footnotesize}
would be available to employees or their union representatives would better enable them to make intelligent investment decisions when the time comes for a collective vote.

Use of the Howey-Daniel test subverts the broad remedial purpose of the Acts. To avoid subjectation to the Acts’ registration and antifraud provisions, an employer need only structure the ESOP’s enactment in such a way as to render it involuntary. When a company proposes an ESOP to its employees, it simply can condition the ESOP’s formation on the outcome of a collective union vote. Those employees in the majority who voted in favor of the plan are under the impression that the Securities Acts will apply. A less-than-unanimous vote, however, might render the interest involuntary, and hence not an investment under the Howey-Daniel test. Current law encourages management to structure the ESOP’s formation in as involuntary a manner as possible in order to preclude application of the Acts. These plans are exactly the type that require special solicitude for employees.

One may question the efficacy of providing prospectuses to relatively unsophisticated employees who probably will not even read

the option plan. The broader the employee group included under the plan, the greater is the need for assuring disclosure of material information . . . .”).

250. See supra note 188 and accompanying text.


252. See supra notes 235-38 and accompanying text.

253. In addition, under the rule of Bauman, a court may find that no sale has taken place in such a case. See supra notes 181-83 and accompanying text.

254. See Baeza & Taylor, supra note 127, at 706-08.

If plan participation is . . . rendered voluntary and contributory, the company may be forced to undergo the expense and delay of registration and could be placed in the awkward position of having to disclose sensitive financial information such as projections.

. . . . . . [W]hen a plan is implemented for a large group of employees on the basis of less-than-unanimous votes, the plan will be considered involuntary and non-contributory for purposes of the Securities Acts.

. . . . . . [A]ny employer considering the solicitation of employee consent in connection with the implementation of an ESOP funded in whole or in part by wage concessions should at the very least be careful to structure the solicitation so that both cutbacks and plan participation are imposed on a group-wide basis and, if employee approval is necessary or desirable, in conjunction with a collective vote.

Id. (emphasis added).
them. Indeed, commentators have questioned whether the entire concept of registration in general actually leads to more intelligent and informed investing.\footnote{255} Whatever the merit of these criticisms, registration of ESOPs would undoubtedly facilitate informed decisionmaking, particularly in the context of collectively bargained-for ESOPs. Unions often retain experienced legal counsel and other experts who can assist the union membership in evaluating the securities that an employer offers. Moreover, mandatory disclosure of sensitive information and the threat of antifraud claims may cause an employing company to think twice before attempting to offer an ESOP that is not in the best interests of employees.

**Potential ERISA Preemption**

Opponents of applying Securities Act coverage to ESOPs, and to employee benefit plans in general, argue that the Employee Retirement Income Security Act of 1974 (ERISA)\footnote{257} regulates ESOPs as employee benefit plans and thus courts need not be concerned with the additional protections afforded by the Securities Acts.\footnote{258} The Supreme Court in *Daniel* held that the existence of ERISA undercut arguments for applying the Acts to pension plans.\footnote{259} Nevertheless, ERISA should present no bar to application of the Acts to ESOPs.

One major criticism of overlapping regulation is a perceived doubling of compliance costs.\footnote{260} The SEC, however, recently has promulgated rules that allow employers to file ERISA-mandated summary plan descriptions (SPDs) in lieu of standard 1933 Act delivery requirements.\footnote{261} Registration costs under current require-
ments therefore should correspond roughly to costs already imposed by ERISA.

If interests in ESOPs are securities, then the fact that ERISA also regulates ESOPs should not preclude application of the Acts. Congress did not condition applicability of the Securities Acts on the nonexistence of alternative regulation, particularly when the instrument at issue has attributes of stock, the paradigm instrument of securities regulation.\(^{261}\) Indeed, when Congress enacted the 1933 and 1934 Acts, it envisioned the concurrent regulation of state blue sky laws.\(^{262}\)

When courts ruled that a particular instrument was not a security, they often relied on the “context” clause of the Acts. Congress prefaced the definitional provisions of both the 1933 and 1934 Acts with the statement beginning “[w]hen used in this chapter, unless the context otherwise requires ... [t]he term ‘security’ means.”\(^{263}\) Some courts interpreting these phrases have construed the term “context” to mean the factual context of the transaction involving the sale of a security, as opposed to the textual context of a particular term within the Acts.\(^{264}\) Under this interpretation, an instrument that the Acts would otherwise classify as a security nevertheless may not be a security if the existence of other factors, such as alternative regulatory schemes, leads a court to conclude that applicability of the Acts is unwarranted.\(^{265}\)

The Supreme Court in *Landreth* most likely rejected this interpretation of the context clause.\(^{266}\) First, the decision reached in

\(^{261}\) See *supra* note 233 and accompanying text.


\(^{263}\) 15 U.S.C. §§ 77b(1), 78c(a)(10); see *supra* note 39.


\(^{265}\) See, e.g., *Marine Bank*, 455 U.S. at 557-59 (exempting certificates of deposit); *Wolf v. Banco Nacional de Mexico*, 739 F.2d 1458, 1463-64 (9th Cir. 1984) (same), cert. denied, 469 U.S. 1108 (1985).

Landreth, based on its facts, is itself an implicit rejection of such an interpretation of the context clause. The purchaser of a business is probably least likely to need coverage under the Acts, yet the Court held such a purchaser to be entitled to the Acts' protections. Second, an expansive interpretation of the context clause would undercut the Supreme Court's recently expressed desire for certainty and consistency in securities regulation because the definition of a security conceivably could vary depending on the existence and adequacy of alternative regulatory schemes of both state and federal legislation and the common law of contracts. Third, a factual interpretation of "context" has the effect of rendering the specific enumeration of instruments in the definitional provisions of the Acts just as meaningless as does universal application of the Howey test. Congress could not have intended the context clause to vitiate other express provisions in the Acts. Strong evidence of legislative intent reveals that the context clause originally was

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intended to refer only to the textual, not factual, context in which the Acts use the terms. 271

A factual interpretation of the context clause also contradicts congressional intent expressed in provisions of both ERISA and the Securities Acts, providing that neither is intended to displace already existing rights and remedies. For example, the 1934 Act expressly provides that "[t]he rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity." 272 Similarly, Congress did not intend ERISA to supersede any existing federal law. 273 Under the Supreme Court's current approach to statutory interpretation, congressional intent is equated with the statutory text. 274 Both of these express provisions therefore compel a finding that ESOPs are subject to the Acts if they are deemed securities.

In addition, ERISA's regulatory scheme presents an inadequate substitute for the protections afforded by the Securities Acts. The Tenth Circuit in Uselton devoted a substantial portion of its opinion to rebutting the assertion that ERISA precludes the Acts' applicability to ESOPs. 275

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271. See Rosin, supra note 41, at 363-64; Steinberg, supra note 41, at 504 n.91. But see Louis Loss, Fundamentals of Securities Regulation 246 (2d ed. 1988) (concluding from the same evidence of legislative intent that Congress did intend the factual context to be taken into account).


273. See 29 U.S.C. § 1144(d) (1988) ("Nothing in [ERISA] shall be construed to alter, amend, modify, invalidate, impair, or supersede any law of the United States . . . or any rule or regulation issued under any such law.").

274. See, e.g., Landreth Timber Co. v. Landreth, 471 U.S. 681, 694 n.7 (1984) (literally applying the Acts to stock sold as a sale of a business despite conceding that Congress' primary concern in enacting the securities laws was regulating publicly traded securities); see also Rosin, supra note 41, at 336 ("The Supreme Court's current view [is] that statutory structure and the common understanding of statutory language are the best evidence of legislative intent . . . ."). See generally id. at 341-51 (reviewing recent cases in which the Supreme Court rejected recourse to a statute's legislative history in order to limit its language).

275. Uselton v. Commercial Lovelace Motor Freight, 940 F.2d 564, 581-86 (10th Cir.), cert. denied, 112 S. Ct. 589 (1991). The Tenth Circuit held that ERISA should only preempt securities regulation if it serves the dual purposes underlying the Acts: one, to compel the disclosure of "relevant, accurate information upon which to base an investment decision," id. at 581 (quoting Holloway v. Peat, Marwick, Mitchell & Co., 879 F.2d 772, 786 (10th Cir. 1989)), and two, to provide adequate remedies for fraud and misrepresentation. Id. at 582. The Court found that ERISA fails to serve those values effectively. Id.
First, ERISA’s disclosure requirements address only employees who are already participants or beneficiaries. Unlike the 1933 Act, ERISA does nothing to assist those considering whether to invest. Moreover, even ERISA-mandated disclosure does not reveal facts regarding the plan’s financing or the issuer’s financial soundness unless the participant specifically requests such information. This information is therefore not automatically disclosed to present participants and is not required to be disclosed at all to potential participants.

Second, although the Secretary of Labor has authority to monitor ERISA plans and to take corrective action on participants’ behalf, the Secretary has only the potential ability to insure that ERISA’s fiduciary and funding obligations are met. With a conventional pension plan, such regulation might be sufficient. The value of an ESOP to employees, however, is not significantly dependent on the employer’s funding and proper management of plan assets. Rather, the ESOP’s value is totally dependent on the value of the employer’s stock and, therefore, on the financial soundness of the employer itself. The 1933 Act, unlike ERISA, allows potential investors access to information that would allow for such a financial assessment.

Third, ERISA provides no remedies to participants whom the employer induces to participate in the ESOP through the use of fraudulent statements or omissions. No ERISA remedies redress

276. Id. at 581 (citing 29 U.S.C. §§ 1021(a), 1024(b)).
278. Uselton, 940 F.2d at 581; see also Ford, supra note 96, at 59-60 (“ERISA requires an employee to make an investment, which significantly affects his future financial security, without the opportunity to obtain sufficient information necessary to make a knowing investment decision or to evaluate the risks involved in the investment.”).
279. Uselton, 940 F.2d at 581. Compare 29 U.S.C. § 1022(b) (requiring disclosure of the source of financing and the identity of organization) with 15 U.S.C. §§ 77e, 77g, 77aa (Schedule A) (enumerating strict registration requirements to be satisfied by the issuer of a security) and Ford, supra note 96, at 50 (“the federal securities laws provide greater protection for investors by providing them with sufficient information about the quality and integrity of a company’s management, its financial condition, and its securities”).
280. Uselton, 940 F.2d at 581-82 (citing 29 U.S.C. §§ 1023, 1024(b)(2), (4)).
282. Uselton, 940 F.2d at 582 (citing 29 U.S.C. §§ 1023, 1081-1086, 1101-1114, 1132(a)(2)).
283. Id.
284. Id.
285. Id.
preparticipation fraud. ERISA's remedies are limited to an award of benefits due under the plan, enforcement of the plan's disclosure, funding and administrative requirements, and appropriate relief for breach of a fiduciary duty by a plan administrator. In contrast, the Securities Acts authorize private actions in order to rescind fraudulent transactions and to recover amounts invested.

Although ERISA complements the Securities Acts, it is far from a duplicative or even adequate protective regulatory scheme from the perspective of the employee-investor, Daniel notwithstanding. One should not read the Supreme Court's dicta in Daniel as holding that ERISA preempts SEC regulation over all employee benefit plans, even those that bear the usual attributes and risks associated with common stock.

OFFER OR SALE FOR VALUE

Once a court has determined the existence of a security, it must still determine whether a sale of a security for value has taken place in order for the 1934 Act's antifraud provisions to apply and whether a sale or an offer to sell for value has occurred in order for the 1933 Act's registration and antifraud provisions to apply.

286. Id. at 583. Unlike the provisions of the 1933 Act, ERISA's limited antifraud provisions do not even apply to fraudulent statements or omissions when made either orally or in written material not required by ERISA. See Ford, supra note 96, at 60-61; supra note 37 and accompanying text.

287. Uselton, 940 F.2d at 582-83 (citing 29 U.S.C. §§ 1109, 1132(a)(1)-(4)).

288. Id. at 582 (citing 15 U.S.C. § 78j(b) (1988) and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1990)).


As a practical matter, this Note questions the ability of the designated ESOP regulators, the Department of Labor and the Internal Revenue Service, to void abusive ESOP transactions. Limited staffing at the Department of Labor strongly suggests that these transactions will overwhelm government oversight capabilities.

Id.

290. See Steinberg & Kaulbach, supra note 41, at 506 ("Justice Powell's dicta in Daniel appears to have been little more than an afterthought . . . .").

291. Despite Daniel, the SEC has maintained persistently that the registration and antifraud requirements of the Securities Acts apply to voluntary and contributory pension plans. See Securities Act Release No. 6188, supra note 33.

292. Whereas the 1933 Act provides that "[t]he term 'sale' or 'sell' shall include every contract of sale or disposition of a security or interest in a security, for value," and "[t]he
The *Daniel* decision never reached this issue with respect to interests in employee benefit plans.\(^{293}\)

In response to the *Daniel* decision, the SEC took the position that the sale of interests in an employee benefit plan occurs when an employee makes an "investment decision" and "furnish[es] value";\(^{294}\) that is, when the plan is voluntary and contributory. With respect to employee benefit plans, therefore, the test that the SEC uses to determine whether a sale has taken place is essentially the same test courts following *Daniel* have used in determining whether a security—an investment contract—exists.\(^{295}\)

The *Howey* test should not be used to collapse these two analyses into one. *Landreth* made clear that the *Howey* formulation should apply only to give meaning to the term "investment contract."\(^{296}\) The same problems of inconsistency and unpredictability result in making distinctions based on the voluntariness of a plan in the context of an ESOP that was the result of collective bargaining.\(^{297}\) Moreover, this approach ignores the 1933 Act's "offer" requirement\(^{298}\) and fails to recognize and protect the expectations of those employees who vote affirmatively to participate in the ESOP.\(^{299}\)

\(^{293}\) See *supra* note 63 and accompanying text.


\(^{295}\) The court in Bauman v. Bish, 571 F. Supp. 1054, 1063-64 (N.D. W. Va. 1983), fell prey to this same flawed approach. See *supra* notes 189-94 and accompanying text.

\(^{296}\) See *supra* notes 79-85 and accompanying text.


\(^{298}\) See *supra* notes 191-94 and accompanying text.

\(^{299}\) See *supra* notes 235-38, 250-54 and accompanying text.
Once an ESOP interest is found to be a security, the question with respect to applicability of the Acts in the context of collectively bargained-for ESOPs then becomes whether the employees have been offered or have purchased a security for value when: they will accept or have accepted wage reductions in exchange for participation in an ESOP, as is often the case; they have voted or will vote collectively, not individually, to accept wage reductions in exchange for ESOP participation; and when an employee’s acquisition of stock is contingent on meeting the vesting requirements of the plan.

The latter two issues arise only with respect to the 1934 Act’s antifraud provisions. Registration requirements and antifraud provisions of the 1933 Act require only an offer to sell a security for value.\(^\text{300}\) Wage reductions implicate the “for value” concerns of both the 1933 and 1934 Acts,\(^\text{301}\) but the issues of collective participation, dealing with acceptance of the employer’s offer, and contingent ownership, dealing with when the transfer of stock ownership is complete, are subsequent to the offer and irrelevant to 1933 Act application. Those issues do relate, however, to the antifraud provisions of the 1934 Act, which requires a complete sale, rather than a mere offer, of a security in order to trigger its protections.\(^\text{302}\)

With respect to the first issue, wage reductions constitute a relinquishment of existing contract rights and should always suffice as an exchange for value within the meaning of the Acts.\(^\text{303}\) Indeed, in cases where courts assumed the existence of a security and the Howey test did not cloud the issue, courts have held that a mere exchange of labor is sufficient to bring an offering and sale of stock to employees within the 1933 and 1934 Acts.\(^\text{304}\) Regardless of the

\(^{300}\) See supra note 29.

\(^{301}\) This statement assumes an implicit “for value” requirement in the 1934 Act’s antifraud provisions. See supra note 292.

\(^{302}\) See supra note 28 and accompanying text.

\(^{303}\) See, e.g., Hood v. Smith’s Transfer Corp., 762 F. Supp. 1274, 1290 (W.D. Ky. 1991); Deutschman v. Beneficial Corp., 761 F. Supp. 1080, 1088 (D. Del. 1991) (payroll deductions given in return for securities is an exchange for value for purposes of the 1934 Act); see also Ziino, supra note 249, at 36 (“The Act is designed to protect persons who part with something of tangible or intangible value in exchange for securities.”).

validity of those cases, however, many companies form ESOPs in order to exact wage concessions from labor unions.305 Accepting a wage reduction constitutes adequate value and is a sufficient investment decision to bring the transaction within the ambit of the 1933 and 1934 Acts.306

The collective nature of ESOP employee participation poses a dilemma to application of the 1934 Act, although not an intractable one. Not all ESOPs call for collective approval. For instance, sometimes employers allow employees to decide on an individual basis whether to participate in the plan.307 Under the current Howey-Daniel regime, however, employers are dissuaded from permitting individual election because this choice renders the plan more voluntary under the first prong of the investment contract test.308

When a majority of union members agrees to accept wage reductions, those who vote with the majority make the requisite investment decision, and for them a sale of a security occurs.309 Those union members in the minority, however, are forced to accept wage reductions in exchange for ESOP participation. To deny completely application of the 1934 Act because some employees vote

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305. See, e.g., Hansmann, supra note 128, at 1804-05.
306. If the employer does not demand wage concessions, services, or any other consideration in return—a possibility, given an ESOP’s tax advantages—then ESOP participation is a true gift and hence no sale or offer for value occurs. If employees have nothing to lose, then registration and antifraud remedies are unnecessary.
308. See supra notes 169-70 and accompanying text.
against participation is harsh, particularly for those in the majority who reasonably expect the Securities Acts to apply.\textsuperscript{310} Two tentative responses to this obstacle of finding a sale are possible. First, by accepting union representation and by participating in the referendum, employees tacitly consent to the outcome of the vote. The employees collectively have made an investment decision and therefore the employees, taken as a whole, should be entitled to the protections of the 1934 Act. Alternatively, the 1934 Act covers dissenting employees under a twist of the judicially crafted forced seller doctrine. Under the forced seller theory, a shareholder forced to sell his shares is still considered a seller of securities for purposes of the Acts.\textsuperscript{311} In the context of collectively bargained-for ESOPs, dissenting employees are "forced buyers." Although no cases have considered the possibility of a "forced buyer" doctrine, no principled reason exists for not applying the same rationale to protect those forced to purchase securities.\textsuperscript{312}

The final issue under the sale rubric of the 1934 Act is that of vesting requirements. In a tangentially related case, the Second Circuit shed some light on the effect of vesting preconditions on the sale requirement. In \textit{Yoder v. Orthomolecular Nutrition Institute, Inc.},\textsuperscript{313} the plaintiff had exchanged her services and certain assets in return for shares of her employer's stock.\textsuperscript{314} Delivery was

\begin{footnotesize}
\begin{enumerate}
\item See \textit{supra} notes 235-38 and accompanying text.
\item The Second Circuit first enunciated the forced seller doctrine in \textit{Vine v. Beneficial Finance Co.}, 374 F.2d 627, 635 (2d Cir.), \textit{cert. denied}, 389 U.S. 970 (1967), in order to extend the 1934 Act's antifraud protections to a shareholder forced to sell his shares as the result of a short-form merger. Courts have applied the forced seller doctrine in contexts other than the short-form merger. See, e.g., Alley v. Miramon, 614 F.2d 1372, 1380-81 (5th Cir. 1980) (applying the doctrine to liquidation); \textit{Crane Co. v. Westinghouse Air Brake Co.}, 419 F.2d 787, 798 (2d Cir.) (discussing disappointed tender offeror "forced" to sell its shares back to target corporation), \textit{cert. denied}, 400 U.S. 822 (1969).
\item A prerequisite to application of the forced seller doctrine is proof of a fundamental change of investment, from an interest in a going enterprise to a right solely to a payment of money. Mosher v. Kane, 784 F.2d 1385, 1389 (9th Cir. 1986); \textit{Jeanes v. Henderson}, 703 F.2d 855, 859-60 (5th Cir. 1983). In the ESOP context, the exact opposite occurs: employees relinquish a right to higher wage payments in return for an interest in a going enterprise. An involuntary conversion exists in either case.
\item This approach could also be applicable when the employer imposes ESOP participation on all employees as a condition of employment; in this situation, all employees would be "forced buyers."
\item 751 F.2d 555 (2d Cir. 1985).
\item \textit{Id.} at 558.
\end{enumerate}
\end{footnotesize}
conditioned on the plaintiff's attaining a certain level of sales, similar to an employee's acquisition of stock in an ESOP being conditioned on meeting vesting requirements. The court stated: "We perceive no reason why a contingency attached to a contractual right to acquire stock should remove that right from securities law coverage simply because it increases the risk that plaintiff will not obtain the shares." In support of this contention, the court cited *Marine Bank v. Weaver*, in which the Supreme Court held that "a pledge of stock is equivalent to a sale for purposes of the antifraud provisions" of the 1934 Act, despite the fact that complete transfer of ownership would occur only in the result of default by the borrower.

Application of these established principles yields the conclusion that preconditions to vesting are immaterial to the sale requirement for purposes of the 1934 Act's antifraud provisions. Nor should the collective nature of ESOP formation preclude application of the 1934 Act. The 1933 Act's registration and antifraud requirements of an offer to sell for value and the 1934 Act's "for value" requirement are met because wage reductions constitute sufficient value.

**Conclusion**

Once the true nature and purpose of employee stock ownership plans are understood, the fact that ESOPs are not the functional equivalent of conventional pension plans becomes clear. ESOPs are grossly inadequate as income deferral devices, and Congress did not intend ESOPs to serve such a function. An employee who participates in an ESOP becomes an investor, acquiring an interest that bears the risks and possesses all the attributes of traditional common stock. Courts should not succumb to the deceptive "employee benefit plan" label and erroneously assume that *Daniel* controls the definitional issue.

315. Id. at 559.
316. Id. at 559 n.4.
318. Id. at 554 n.2.
319. Id.; see also Rubin v. United States, 449 U.S. 424, 430 (1981) ("It is not essential under the terms of the Act that full title pass to a transferee for the transaction to be an 'offer' or a 'sale.' ").
Landreth is decisive authority for applying the Securities Acts' definitional provisions literally when possible. ESOPs constitute certificates of interest or participation in stock and therefore fall within the purview of the Acts by default. Such an approach is far superior to the inconsistent and unpredictable Howey-Daniel formulation; it comports with congressional intent and best protects investing employees.

As companies continue to form ESOPs with increasing frequency, employees particularly need the Acts' protections because ESOP formation carries the potential for abusive and fraudulent tactics and workers are relatively lacking in financial sophistication. Employees justifiably expect that the Securities Acts will apply to the sale of instruments that possess all the common attributes of stock and which the employer promotes as stock.

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