Regulatory Uncertainty: General Economic Principles and the Case of Employee Stock Ownership Plans

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SEPTEMBER 2023

MATRIX GLOBAL ADVISORS

Executive Summary

Regulations have the potential to yield societal benefits, but poorly designed or administered regulations can impose significant burdens. Some costs associated with regulations can be measured, but one aspect that imposes a significant unmeasured cost is regulatory uncertainty. This paper details the consequences of regulatory uncertainty for businesses and provides a close look at the ongoing uncertainty facing companies owned by employee stock ownership plans (ESOPs).

REGULATORY UNCERTAINTY

Regulatory uncertainty arises when, for example, regulations are proposed but not finalized; are subject to legal challenge; are in effect but, at the discretion of the regulatory agency, are not enforced; are interpreted or applied inconsistently by the regulator; or are at risk of being overturned when the opposing political party takes power.

Regulatory uncertainty increases risk and can delay or impede business decisions and investments. The costs this uncertainty creates for businesses are particularly acute for small firms that may lack the resources to navigate complex or opaque regulatory regimes.

Academics have investigated the impact of regulatory uncertainty on economic outcomes. One consequence is a chilling effect on investment and innovation. Uncertainty can make it difficult for firms to assess risks and opportunities and may inhibit firms' investment in new technologies and hiring decisions. Uncertainty has also been shown to reduce business investment and employment growth, raise precautionary savings, and increase stock price volatility.

THE CASE OF ESOP REGULATION

An ESOP is a type of employee benefit plan that essentially allows a company's employees to gain an economic ownership interest in their company without using their own money. The most common form of ESOP structure is an ESOP-owned S corporation, or S ESOP.

Key to the setup, functioning, and administration of an ESOP is a fair market valuation of the firm since an ESOP, by law, cannot pay more than fair market value. For decades, ESOPs and their advisors have faced regulatory uncertainty related to private company valuation, which is an inexact science at best. In particular, a lack of formal regulatory guidance from the Department of Labor (DOL) has left ESOPs reliant on informal guidance from private settlement agreements with ESOP fiduciaries, a hodgepodge of conflicting DOL and private plaintiff court cases, and the observed (and inconsistent) outcomes of DOL enforcement (which varies by regional office).

Regulatory uncertainty for ESOPs stemming from disparate and sometimes aggressive DOL enforcement has given rise to an opportunistic plaintiffs bar that exploits the inconsistent applications of the law. One consequence of the increase in activity by plaintiff attorneys is an increase in insurance costs. As such, there are higher costs associated with ESOP transactions, and less economic incentive for a business owner to pursue an ESOP.

While Congress recently directed DOL to establish guidance for ESOP fair market valuation (50 years after originally directing DOL to do so), the new legislation lacks any statutory deadline for the guidance. This persistent regulatory uncertainty creates burdens and risks that can discourage employee ownership and hamper ESOP-owned businesses.

Introduction

In 2022, the federal government finalized 260 regulations, slightly more than one per business day. This large number, which is actually below the historical average, reflects the broad scope of the federal regulatory apparatus in the United States. Regulations cover industries from agriculture to transportation and pertain to workers, taxes, safety, education, and a range of other areas. Many regulations are updated and revised annually, causing perpetual regulatory churn, while others have been in effect for decades, sometimes reflecting outdated assumptions and business practices.

Regulations have the potential to yield social and economic benefits (for example, rules that ensure safe working environments, clean rivers, or a level playing field among competitors). However, regulations that are poorly designed or administered, even with the best intentions, can impose significant burdens on those being regulated as well as ancillary actors, including customers, workers, and communities.

The costs and burdens of federal regulations can be measured in a multitude of ways. For example, the federal government regularly estimates the paperwork burden of regulations and, for major regulations, analyzes the broader economic impact. The annual paperwork burden of regulations finalized in 2022 exceeds an estimated 85 million hours, and regulations in effect from previous years pushes that estimate to more than 1 billion hours.[1] In reality, the actual cost of regulations can greatly exceed government estimates. Ineffective or poorly administered regulations, for example, can raise costs for businesses and discourage productive investments.

This paper focuses on one aspect of regulations that imposes a significant unmeasured cost on businesses: regulatory uncertainty. Section 1 discusses modern executive orders governing regulatory agencies, the economic justification for regulations, and the framework for analyzing regulations. Section 2 reviews the economic literature on the role of regulatory uncertainty in business activity. And section 3 highlights the burden of regulatory uncertainty on companies owned by their employees through employee stock ownership plans (ESOPs).

1. History, Economics, and Analysis of Regulations

In 1993, President Bill Clinton issued Executive Order (EO) 12866 in response to significant concerns about the state of the regulatory system. In an effort "to restore the integrity and legitimacy of regulatory review and oversight," EO 12866 directs agencies to only pursue regulations when necessary and to choose regulatory approaches that maximize benefits while minimizing unreasonable costs (*White House, 1993*).

In conjunction with EO 12866, the Office of Information and Regulatory Affairs (OIRA) within the Office of Management and Budget was directed to write a report on the implementation of the order. This report succinctly explains the purpose and utility of federal regulations while

[1] See Regulation Rodeo at www.regrodeo.com for estimated burdens by year since 2005. Many experts have commented that the federal government has underestimated paperwork burdens for various regulations.

acknowledging the reality that they can be harmful:

> It is conventional wisdom that competition in the marketplace is the most effective regulator of economic activity. Why then is there so much regulation? The answer is that markets are not always perfect and when they are not, society's resources may be imperfectly or inefficiently used. The advantage of regulation is that it can improve resource allocation or help obtain other societal benefits. . . . Excessive or poorly designed regulations, by contrast, can cause confusion and delay, give rise to unreasonable compliance costs in the form of capital investments and on-going paperwork, retard innovation, reduce productivity, and accidentally distort private incentives. (*OIRA, 1994*)

Eighteen years later, EO 13563 reaffirmed the definitions and structures established in EO 12866. Most importantly, EO 13563 directs regulatory agencies to allow time for public comment on a proposed regulation and, where appropriate, to seek the views of those affected by the proposed rulemaking (*White House, 2011*).

Missing from conventional cost-benefit analyses are the burdens associated with regulatory uncertainty.

As established in EO 12866, the conventional tool for regulatory analysis is the cost-benefit framework, whereby analysts estimate the expected real and social costs and benefits of a regulation, ideally in monetary terms, and discount future costs and benefits to the present period. Many costs and benefits are difficult to monetize, or monetary values are uncertain, but cost-benefit analyses can at least help policymakers more accurately assess whether the benefits of a proposed regulation are likely to outweigh its costs. Missing from conventional cost-benefit analyses, however, are the burdens associated with regulatory uncertainty.

2. Role of Regulatory Uncertainty in Business Activity

EO 12866 stipulates that "each agency shall draft its regulations to be simple and easy to understand, with the goal of minimizing the potential for uncertainty and litigation arising from such uncertainty." In reality, regulatory uncertainty is difficult to mitigate and presents tangible challenges for businesses and consumers. Regulatory uncertainty arises when, for example, regulations are proposed but not finalized; are subject to legal challenge; are in effect but, at the discretion of the regulatory agency, are not enforced; are interpreted or applied inconsistently by the regulator; or are at risk of being overturned when the Executive changes party.

Regulatory uncertainty increases risk and can delay or impede business decisions and investments. The costs this uncertainty creates for businesses are particularly acute for small firms that may lack the resources to navigate complex or opaque regulatory regimes.

For years, academics have attempted to empirically investigate the impact of regulatory uncertainty on economic outcomes. One consequence is a chilling effect on investment and innovation. Uncertainty can make it difficult for firms to assess risks and opportunities and may inhibit firms' investment in new technologies (*Marcus, 1981*). Dixit and Pindyck (1994) examine firms' investment decisions in the face of uncertainty and demonstrate that increases in uncertainty raise the value of waiting, leading to decreases or delays in firms' decision-making.

Bachmann and Bayer (2013) and Bloom (2014) show how increased uncertainty impedes firms' ability to accurately predict payoffs, resulting in a "wait and see" effect with respect to investment and hiring decisions. More specifically, policy uncertainty has been shown to reduce business investment and employment growth, raise precautionary savings, and increase stock price volatility (*Bloom, 2014*; *Gulen and Ion, 2016*).

Baker, Bloom, and Davis (2016) measure economic uncertainty using a set of terms related to regulation in news articles. They also find that stock price volatility increases with policy uncertainty and that increases in uncertainty reduce investment and employment in policy-sensitive sectors. Particularly noteworthy considering the next section's focus on conversions of privately held companies to ESOPs, Bonaime, Gulen, and Ion (2018) find that policy and regulatory uncertainty are negatively associated with competing forms of business structure change and merger and acquisition activity.

Sinclair and Xie (2021) and Xie (2022) evaluate nearly 500,000 news articles from major media outlets using a lexicon-based search analysis to construct an index of regulatory uncertainty by industry. They find that spikes in regulatory uncertainty result in negative (but transitory) effects on business output and employment in general and long-lasting adverse effects when the regulations relate to labor and the workplace.

More generally, an example of the burdens of regulatory uncertainty can be drawn from land-use regulations such as building codes, zoning regulations, and permits for use and construction. Numerous researchers have studied the effects of local housing regulations on housing starts, construction delays, and land and home prices. Gyourko and Krimmel (2021), for example, find that zoning regulations in certain US residential markets can increase the price of a quarter-acre housing lot by more than $100,000 in each of five large metro markets, thereby raising home prices and significantly impeding housing affordability. Mayer and Somerville (2000) observe that, from "a policy perspective, our results suggest additional social costs to policies that regulate through adding delay or uncertainty. We show that such policies reduce the ability of builders to respond quickly to market signals and may even encourage a less stable aggregate housing market."

A compelling example of the real-world effects of regulatory uncertainty can be found in the case of ESOPs.

3. The Case of ESOP Regulation

An ESOP is a type of employee benefit plan that essentially allows a company's employees to gain an economic ownership interest in their company without using their own money. The shares of an ESOP business are held in a trust account that employees own all or part of, and workers are awarded shares based on their salary and years of service. Should workers leave the company, the company or trust buys back their shares at fair market value. The most common form of ESOP structure is an ESOP-owned S corporation, or S ESOP.

Many studies over the last several decades have shown that S ESOPs tend to perform better than their peers, improve worker commitment, increase firm productivity, reduce worker turnover, and lower production costs (*Brill, 2016*).

In addition, S ESOPs have proven resilient in the face of economic downturns, and this resilience has positive ripple effects for S ESOP suppliers and local economies (*ibid.*).

REGULATORY UNCERTAINTY AROUND ESOP VALUATION

Key to the setup, functioning, and administration of an ESOP is a fair market valuation of the firm since an ESOP, by law, cannot pay more than fair market value. This valuation is necessary for a company's transition to ESOP ownership, and then on an annual basis for valuing shares held in employee accounts. Given the lack of a public market to establish the share value, the valuation of privately held companies can be imprecise, as it is subject to differing analytical inputs and applications of generally accepted methodologies.

For decades, ESOPs and their advisors have faced regulatory uncertainty related to private company valuation, which is an inexact science at best. In particular, a lack of formal regulatory guidance from the Department of Labor (DOL) has left ESOPs reliant on informal guidance from private settlement agreements with ESOP fiduciaries, a hodgepodge of conflicting DOL and private plaintiff court cases, and the observed (and inconsistent) outcomes of DOL enforcement (which varies by regional office).

In some cases, the most authoritative regulatory guidance is a proposed DOL regulation from 1988. Even though a proposed regulation has no legal power, some courts have adopted aspects of the proposed rule in their determinations.

Further deepening the uncertainty, there have been instances of DOL actions contradicting the proposed 1988 regulation. For example, the proposed regulation notes that "the fair market value of an asset will ordinarily be identified by a range of valuations rather than a specific, set figure" (*DOL, 1988, 17634*). In practice, however, some DOL field-office personnel have held that only a single, specific value for an ESOP firm's stock is valid.

Other concerns, many of them more nuanced, abound as well. For example, prevailing valuation theory related to privately held companies holds that if a company is valued based on its existing, "as is" level of earnings — without making any upward adjustments to those earnings based on certain actions a hypothetical buyer might take — applying a discount to the result would be inappropriate. Unfortunately, DOL has, on occasion, opined that unless an ESOP obtains certain rights to direct the operations of the company above and beyond what a majority shareholder of a non-ESOP company would typically get, regardless of whether any adjustments to the company's earnings were made in the valuation, then a material discount should apply. This position is inconsistent with the general understanding of what fair market value means, further sowing uncertainty in the market.

CONSEQUENCES OF REGULATORY UNCERTAINTY

Regulatory uncertainty for ESOPs stemming from disparate and sometimes aggressive DOL enforcement has given rise to an opportunistic plaintiffs bar that exploits the inconsistent applications of the law. An analysis of ESOP litigation over the past decade finds that judgments and settlements in 68 cases over this period totaled $385.5 million (*Rosen, 2023*). Fifty-four of these cases related to fair market valuation. While the vast majority of cases ended in a settlement, legal costs were substantial even in cases where the defense prevailed or reached a favorable business outcome.

One consequence of the increase in activity by plaintiff attorneys is an increase in insurance costs. As such, there are higher costs associated with ESOP transactions, and less economic incentive for a business owner to pursue an ESOP.

As a result, business owners who would have been open to an ESOP may decide that it is not worth the potential regulatory and litigation risk and instead sell to a competitor or private equity firm. Thus, the cost of uncertainty ends up being borne by workers who otherwise could have reaped the benefits of employee ownership.

EFFORTS TO ADDRESS REGULATORY UNCERTAINTY

In recognition of the burden of regulatory uncertainty related to ESOP valuation, Congress enacted Section 346(c)(4)(B) of Division T of the Consolidated Appropriations Act of 2023, which requires that the Secretary of Labor, in consultation with the Secretary of the Treasury, issue formal guidance for "acceptable standards and procedures to establish good faith fair market value for shares of a business to be acquired by an employee stock ownership plan (as defined in section 407(d)(6) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1107(d)(6)))." This provision was contained within the section on Worker Ownership, Readiness, and Knowledge (WORK) in the Division of the Consolidated Appropriations Act commonly referred to as the SECURE 2.0 Act of 2022.

While a congressional directive to DOL to establish guidance for ESOP fair market valuation (50 years after Congress originally directed DOL to do so) is certainly an *attempt* at reducing regulatory uncertainty, the legislation unfortunately lacks any statutory deadline for the guidance. In the meantime, employees who own their companies through an ESOP bear the cost. It is critical that DOL issue guidance for ESOP valuation promptly through a formal notice-and-comment rulemaking that permits stakeholders to offer feedback on a proposed regulation.

Conclusion

At their best, regulations yield societal benefits that outweigh their costs. Regulatory uncertainty, however, represents one burden of regulations with no countervailing benefit. Uncertainties include the risk that a proposed regulation may or may not be finalized or, if finalized, may be overturned by a court. They also include ambiguities related to a final rule, such as variation in how, when, or if regulators apply the rule. Costs related to regulatory uncertainty extend beyond those arising from simply complying with the law — they can include delays in firms' investment decisions and lost business opportunities. In the case of ESOPs, regulatory uncertainty creates burdens and risks that can discourage employee ownership and hamper employee-owned businesses.

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