

Employee stock ownership plans and the modern corporation:  
A detriment to all involved parties.

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DRAFT ALL USUAL CAVEATS APPLY

**Abstract:** The Modern perception of the employee stock ownership plan or ESOP, is one of benefit to all. The academic circles, public and media perceive them as a way of placing the employee on equilateral footing while giving them additional motivation through direct ownership of the firm. In reality ESOP's represent additional risk to labor and the firm and are enacted as a defensive measure by management or as a tax shelter. Thus, ESOP's ultimately hurt everyone in the channel.

## **Introduction**

Employee stock ownership plans or ESOP's represent the culmination and emergence of a hybrid form of collective socialism mixed with modern empirical capitalism. The current research indicates time and again that socialism and collectivism fails when economies. Repeatedly socialism has lead to economic data fabrication by government and various groups, innovation is stifled and centralization creates stagnation in all industrial sectors. As a mirror to socialism ESOP's represent, on a microscale, the hybridization of socialism and capitalism. This twisted abomination ultimately creates outcomes which mirror what is seen in all cases of socialism, failure and economic stagnation. Though by the public and media ESOP's continue to be hailed as a good thing, they ultimately hurt the corporation.

Today, the modern organization operates within the parameters of the stockholder model. This model is designed around external groups owning shares, shares are sold externally to raise capital for the firm and these external owners entrust individuals within the firm to operate in their best interests. This is commonly referred to as agent theory (Principal-agent problem, 2006). Employee stock ownership plans, therefore lead to a regression of agent theory by taking control out of external parties and allowing more control internally. This "entrenchment" leads to behaviors that contradict the concepts dictated by the principles of the modern corporation, that being maximization of shareholder wealth. Thus, employee stock ownership, like other forms of "corporate social responsibility and welfare" is, as Friedman would put it, "nothing short of pure and unadulterated socialism" (Friedman, 1970). As socialism, it again, mirrors what we have seen on a macroscale in all economies that have utilized that economic model, stagnation.

In a democratic and capitalistic economy labor should never dictate the behavior of the firm. When labor dictates how the organization is to be run or directed the individuals self interests are the main concern. Labor is neither concerned with the corporation or the long term sustainability of the firm in a competitive environment. The goals of labor, in short, are concerned with maximization of the individual utility, not that of the long term sustainability of the firm or maximization of shareholder return. Giving labor an increased voice, time and again, has led to firms not operating with the maximization goal in mind. It was argued in Vanek (1975), Drucker (1978) and Aoki (1984) that employee ownership would lead to a convergence of the employee interests and could introduce a smoothing mechanism into labor market cycle. The research indicates that this was and is not the case. At worst, labor has used its voice to stifle progress; at best it leads to a short term benefit within the firm due to a temporary increase in morale or productivity. However the evidence for short term gains as a result of ESOP's have mixed outcomes, ultimately the empirical evidence supports this contention (Faleye, 2005). In reality, the deployment of an ESOP is not as altruistic as it seems. In reality it is a method for tax sheltering and entrenchment by management, not a philanthropic technique as popular literature and perceptions argue.

### **Background**

In the 1960's the stage was set and for entrance of the first of many great corporate fiascos, enter the fall of the Studebaker Corporation. With the fall or bankruptcy of Studebaker Corporation the pensions and retirements of many thousands of its employees were lost. As a result of this financial failure and the impact the failure had on the "common man", the government would implement a series of legislative actions that would change the change the way corporate America operated. The federal government acknowledging the gravity of the Studebaker

situation passed the Employee Retirement Income Security Act (ERISA) of 1974 (Wooten, 2001). This would be mirrored in the early 21<sup>st</sup> century with the fall of the Enron Corporation.

As a result of the tax benefits imparted by ESOP's they would continue to grow into the 80's and 90's and then, in the early part of the 21<sup>st</sup> century, we would be forced to look back at the past as indicative of the future. The Studebaker failure, as previously discussed would be echoed in the failure of the Enron Corporation. Once again many thousands of individuals and institutions would lose billions due to the handling of finances by the top management and crafty accounting. As a result of the ESOP model, many top managers are awarded shares as part of additional compensation packages. What is seen is a concentration of shares in the hands of top management (Blatt, 1994). Thus, the motivation for management is the increase in share value at any cost. Hence, the managers operate any way they see fit to achieve this goal. Directly, as a result of ESOP's, the employee is forced to bear an inordinate amount of risk.

### **An ESOP is a defensive strategy**

Conventional wisdom, the media and public have praised the concept of the employee owned firm. They argue that it provides a tangible motivating factor for the employee's by giving them a direct "stake in the firm's success. This argument is backed up by many academic studies would even produce evidence that this is the case. However, more realistically, the ESOP's emerges for a variety of reasons that do not favor the worker. For instance, they are often setup as a way for management to further entrench itself in the event of a perceived hostile takeover. As a result the external bidders can and do become more reluctant to approach the firm and labor, fearing for job loss, will vote tends to vote with the firm to protect itself (Faleye, 2005). This strategy has

been implemented on several occasions, most notably of which is the case of Shamrock vs. Polaroid (Blatt et al, 1994).

### **ESOP's are a tax shelter and provide a means for raising capital**

ESOP's also offer a wide range of financial benefits for the firm. Most importantly, a solid tax write off while allowing the firm to raise capital based on the sales of shares to the employee (Buxton and Gilbert, 2004). More so the IRS treats stock options as if they have zero value at the time they are issued, so no tax is required to be paid (Blair and Kruse, 1999) until the stock option is exercised.

Further the firm can also borrow against the ESOP and from a tax standpoint for every \$1,000,000 in debt repaid through an ESOP there is approximately a \$400,000 corporate tax savings (Buxton, et al., 2004). Thus, the various financial incentives of issuing an ESOP are clear.

### **ESOP – They hurt performance**

ESOP's ultimately hurt the performance of the firm. The goals of labor are concerned with short term goals and the individuals utility. The firms with ESOP tend to be very risk averse and they can, at times, use their voice as a tool for dissent. When utilized in this factor labor can be the dark horse on any board which leads to decisions, which would be advantageous to the firm, not being made. Ultimately, what matters to labor is being paid its wage, thus, short term individual utility maximization. Evidence for the negative impact has been proven statistically by the empirical studies in Faleye (2006). Faleye discovered the average total factor productivity residual for labor voiced firms, that is a firm with employee ownership, is -.011, significantly below the .070 average for other firms at the at the 1% level. Similarly median productivity for

labor voice firms is  $-.032$  compared with  $.050$  for other firms. Thus, non-labor controlled firms represent 105% of what we would expect based on factor inputs and labor voice firms only manage about 97% of the expected output on average. The statistical data clearly disputes the common misconception that labor has a “positive” impact on firm productivity.

Further reiterating this point in a study by Kruse and Blasi (1998) showed that firms pre vs. post ESOP demonstrated annual sales growth of  $+2.4\%$ , annual employment growth of  $+2.3\%$ , annual growth in sales per employee at  $2.3\%$  and an average increase in productivity at  $+4.5\%$  (1998). These figures are quickly called into question as the reasons for this growth are not truly statistically significant. Even more so, average inflation is roughly 2% to 3% and these seeming positive figures indicate they are actually the result of various market forces, not labor’s perceived positive impact.

### **ESOP – they are good for the employee?**

Besides the negative impact both on and by labor as discussed earlier the clear answer to the question “are ESOP’s good for the employee?” the answer is No. ESOP’s increase the risk to the employee because oftentimes employee retirement plans tend to ignore standard diversification techniques and, as a result, take on an increased level of risk. As discussed in Maggs 2003:

“Enron workers lost more than \$1 billion of their retirement savings because they were pressured to invest their 401 (k) savings in company stock. This is a widespread problem at many major companies, where workers have as much as 90 percent of their 401 (k) assets in company stock.”

Thus, employees at firms with ESOP’s tend to inherently accrue more risk as their portfolios tend to be heavily laden with parent company stock. As Maggs (2003) goes further, ESOP’s are exempt from standard diversification requirements as defined by law. They are not subject to the legislation that restricts the lending between a plan and a party in interest. Further, as

demonstrated in Maggs, employees often are often granted very limited disclosure of pertinent financial information as demonstrated in the Enron case. In this case the company utilized crafty accounting techniques to mask their losses in the foreign subsidiaries. As a result, neither the market nor stock holders had a true picture of what was occurring within the firm. In a single day, the stock price dropped precipitously and, like Studebaker, many thousands lost their life savings.

### **ESOP – the motivator**

ESOP is not a sufficient motivator as common wisdom dictates and further the improvements demonstrated as a result of the issuing of an ESOP are often not statistically significant. However, there are a variety of external factors that can be effectively cited are the true cause of the short term gain. These factors range from technological improvements, to new methodologies' to the impact inflation. As a result, the improvements seen as the result of ESOP and used to demonstrate the effect of ESOP's, when coupled with these tangible factors cause the previous data to become irrelevant. ESOP's do not add value to the employees or the firm.

ESOP's do however; increase the employee's sway on corporate decision making (Faleye, 2006). This, ultimately, has an adverse impact on the firm. It has been shown in (McElrath and Rowan, 1992) that unions use it (ESOP's) as a way to restrict management's independence. McKersie (1999) recounts an interview with a labor appointed board member: "If you work within the system, you can either get a lot accomplished or get some projects struck down, even though your opinion may at first be in the minority". Thus, the ESOP hampers the development, enrichment and evolution of the firm.

### **Conclusions**

ESOP's emerge for a variety of reasons that are not altruistic as the public, labor and media often perceive. ESOP's are defensive mechanisms by a corporation or implemented for the purely financial or internal political benefit. In Scholes and Wolfson (1990) it is argued that ESOP's emerge as a purely anti-takeover strategy. ESOP's do not perform in any truly statistically significant way better than their counterparts and in firms with ESOP's the employee shoulders an increased level of risk personal financial risk. This can be attributed to crafty accounting, poor information disclosure and even ineffective management entrenching themselves through the ESOP.

As a result, there is a growing body of evidence to show that labor does not operate in line with agent theory and, as a result, is only concerned with short term implications and maximization of , not shareholder value maximization. Operating with the short term and not long term or maximization of wealth places the corporation at risk, and the individual's livelihood at risk. Tobin's Q (Tobin, 1969) substantiates this assumption, and in the end, Tannenbaum et al. found no significant correlation between ownership and profitability (1984) Firms with ESOP tend to have poorer stock returns than the industry average and further, leading up to the issuing of an ESOP their debt levels are usually dramatically higher than their peers, making them vulnerable to takeover. The ESOP emerges as a defensive strategy to dissuade potential takeover due to increased vulnerability. Further, the issuing of an ESOP provides an additional resource which the firm can raise capital and also borrow against to help pay off debt.

Prior to most ESOP actions firms tended to demonstrate an increase in their level of debt averaging 11% (Pugh et al, 2000) and as a result, are more susceptible to hostile takeover. The stockholders often during these dramatic increases in debt put the current board at risk and the firm at an increased risk of bankruptcy. As a result, the deployment of an ESOP, as

demonstrated time and again, becomes a purely defensive strategy by current management. More of the stock enters friendly hands; the firm can borrow against the stock, decrease their debt and further entrench themselves. Further, the tax savings coupled with the debt repayment can allow a firm to “look” even more profitable. In the end, the shareholder and the employee lose as a result of the ESOP. Productivity goes down, the financial statements look better, bad leader’s gain a firmer foothold and the shareholder are none the wiser. In the end, all the stakeholders lose as a result of the negative impact on the entire channel that emerges through the ESOP. It is clearly a shockwave that, when left unchecked, ultimately hurts all involved parties.

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