**No. 19-2485**

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**IN THE UNITED STATES COURT OF APPEALS**
**FOR THE FOURTH CIRCUIT**

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SHARON LEE, on behalf of herself individually, and all others similarly situated,

*Plaintiff-Appellant*,

v.

ARGENT TRUST COMPANY, CHOATE CONSTRUCTION COMPANY ESOP COMMITTEE, CHOATE CONSTRUCTION COMPANY BOARD OF DIRECTORS, WILLIAM MILLARD CHOATE, DAVE PRIESTER, COMMITTEE DEFENDANTS (JOHN AND JANE DOES 1-10), BOARD DEFENDANTS (JOHN AND JANE DOES 11-20), AND SELLING SHAREHOLDERS (JOHN AND JANE DOES 21 THROUGH 35),

*Defendants-Appellees.*

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On Appeal from the United States District Court
for the Eastern District of North Carolina

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# BRIEF OF *AMICUS CURIAE* NATIONAL CENTER FOR EMPLOYEE OWNERSHIP IN SUPPORT OF DEFENDANTS-APPELLEES FOR AFFIRMANCE

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UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

**DISCLOSURE STATEMENT**

- In civil, agency, bankruptcy, and mandamus cases, a disclosure statement must be filed by **all** parties, with the following exceptions: (1) the United States is not required to file a disclosure statement; (2) an indigent party is not required to file a disclosure statement; and (3) a state or local government is not required to file a disclosure statement in pro se cases. (All parties to the action in the district court are considered parties to a mandamus case.)
- In criminal and post-conviction cases, a corporate defendant must file a disclosure statement.
- In criminal cases, the United States must file a disclosure statement if there was an organizational victim of the alleged criminal activity. (See question 7.)
- Any corporate amicus curiae must file a disclosure statement.
- Counsel has a continuing duty to update the disclosure statement.

No. 19-2485 Caption: Sharon Lee v. Argent Trust Company

Pursuant to FRAP 26.1 and Local Rule 26.1,

National Center for Employee Ownership ("NCEO"), a 501(c)(3) nonprofit charitable organization
(name of party/amicus)

who is amicus curiae, makes the following disclosure:
(appellant/appellee/petitioner/respondent/amicus/intervenor)

1. Is party/amicus a publicly held corporation or other publicly held entity? ☐YES ☑NO

2. Does party/amicus have any parent corporations? ☐YES ☑NO
If yes, identify all parent corporations, including all generations of parent corporations:

3. Is 10% or more of the stock of a party/amicus owned by a publicly held corporation or other publicly held entity? ☐YES ☑NO
If yes, identify all such owners:

4. Is there any other publicly held corporation or other publicly held entity that has a direct financial interest in the outcome of the litigation? ☐YES ☑NO
If yes, identify entity and nature of interest:

5. Is party a trade association? (amici curiae do not complete this question) ☐YES ☑NO
If yes, identify any publicly held member whose stock or equity value could be affected substantially by the outcome of the proceeding or whose claims the trade association is pursuing in a representative capacity, or state that there is no such member:

6. Does this case arise out of a bankruptcy proceeding? ☐YES ☑NO
If yes, the debtor, the trustee, or the appellant (if neither the debtor nor the trustee is a party) must list (1) the members of any creditors' committee, (2) each debtor (if not in the caption), and (3) if a debtor is a corporation, the parent corporation and any publicly held corporation that owns 10% or more of the stock of the debtor.

7. Is this a criminal case in which there was an organizational victim? ☐YES ☑NO
If yes, the United States, absent good cause shown, must list (1) each organizational victim of the criminal activity and (2) if an organizational victim is a corporation, the parent corporation and any publicly held corporation that owns 10% or more of the stock of victim, to the extent that information can be obtained through due diligence.

Signature: /s/ Shannon M. Barrett Date: June 9, 2020

Counsel for: NCEO



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## INTEREST OF AMICUS CURIAE[1]

The National Center for Employee Ownership ("NCEO") is a nonprofit organization that has been supporting the employee ownership community since 1981.[2] The mission of the NCEO is to help employee ownership thrive. The NCEO is the leading source of unbiased information about employee ownership, providing its members and the public with reliable information to help them make informed decisions about employee ownership. In particular, the NCEO generates original research, including extensive data compilations on ESOP and equity compensation, facilitates the exchange of best practices at its live and online events, and provides publications written by experts in the field.

Public policy since 1974 has strongly encouraged employee ownership, especially through employee stock ownership plans ("ESOPs"). The arguments Plaintiff-Appellant has advanced in this lawsuit about ESOPs generally and ESOP stock purchase transactions in particular are very much at odds with this policy and

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[1] The parties have consented to the filing of this brief. No counsel for a party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than amicus curiae or its counsel made a monetary contribution to its preparation or submission.

[2] The NCEO has over 3,000 organizational and individual members. Membership fees are one source of dependable funding for the NCEO. In submitting this brief, however, the NCEO does not seek to represent its members or their views, nor does it submit this brief on behalf of any of its members.

the empirical research on employee ownership. The *amicus curiae* supporting Plaintiff-Appellant, for example, maintains that ESOPs "subject[] employees to enormous, uncompensated risk" and that ESOP transactions "involve inherent risks" and are "vulnerable to abuse."[3] While ESOPs, like any corporate structure, can be subject to abuse and risk, the implication that ESOPs are inherently excessively risky and abusive is contrary to the best academic research. These unsubstantiated statements undermine Congressional intent to encourage employee ownership. The NCEO therefore has a strong interest in clarifying what the available data show with respect to employee ownership so that the Court and its members can evaluate party litigation positions in the context of reliable information.[4]

## ARGUMENT

The district court evaluated a transaction in which an ESOP purchased eight million shares of stock in a privately held company for $198 million, financed 100% of the purchase price with debt, and ended up with shares valued at $64.8 million a few weeks after the transaction closed. The use of debt to finance such transactions is common; among other considerations, debt financing allows the ESOP and the

[3] Doc. 23 at 5, 7-8.

[4] "It is a capital mistake to theorize before one has data. Insensibly one begins to twist facts to suit theories, instead of theories to suit facts." Sir Arthur Conan Doyle, *A Scandal in Bohemia*, 1891. "In God we Trust; all others must bring data." W. Edwards Deming (first stated by Professor Robert Fischer in 1978 testimony to U.S. House of Representatives on effects of smoking).

ESOP-owned company to avail themselves of favorable tax treatment. What is more, the positive post-transaction equity value of the ESOP's stock indicates that the purchase price was favorable to the ESOP as buyer, such that it realized an almost immediate benefit from the purchase. The district court properly dismissed Plaintiff-Appellant's complaint because she failed to identify any injury that resulted from the transaction. In short, the district court understood the difference between the $198 million purchase price, which is based on the company's enterprise value (*i.e.*, the company's fair market value unencumbered by the transaction debt), and the $64.8 million equity value, the value of the purchased equity less the transaction debt.

In challenging the district court's decision, Plaintiff-Appellant not only mischaracterizes the subject transaction,[5] but also attacks the core concepts of ESOPs and ESOP stock purchase transactions.[6] The legislative history makes clear that there has been essentially unanimous and sustained Congressional support for

[5] Doc. 20 at 36 (conflating enterprise value with equity value in arguing that, "the ESOP as a whole suffered a loss from overpaying for Choate stock"); *see also* JA010, JA019 (alleging that the "purchase price of $198 million was too high" based on the following incorrect reasoning: "Choate stock was valued at just $64.8 million less than a month after its sale to the ESOP, meaning the stock has lost 2/3 of its value as of December 31, 2016.").

[6] *See, e.g.*, Doc. 23 at 5, 7-8 (maintaining, as *amicus curiae* supporting Plaintiff-Appellant, that employee stock ownership plans "subject[] employees to enormous, uncompensated risk" and that ESOP transactions "involve inherent risks" and are "vulnerable to abuse.").

ESOPs. The research on ESOPs also makes it clear that ownership through an ESOP has made retirement more secure and more accessible for participants, not less, and ESOPs are not per se risky and fraught with abuse. The major employee ownership studies meeting academic standards, cited herein and listed in Appendix A to the attached Addendum, likewise upend this position: the available data show that ESOPs have outperformed 401(k) plans in terms of asset growth, and that employee owners have higher compensation, more job security, and greater job satisfaction than non-employee owners. For these reasons, discussed further below, this Court should reject any negative presumption regarding ESOPs, should recognize what the figures alleged in the Complaint truly reflect about the prudence of the stock purchase transaction, and should affirm the judgment of the district court.

## I. The Data Show That ESOPs Are More Successful Overall in Building Retirement Wealth Than Other Retirement Savings Programs.

The most common structure for broad-based employee ownership in the U.S. is the ESOP.[7] As of 2016, the most recent year for which data are available, there were 6,624 ESOPs in the United States, holding total assets of nearly $1.4

[7] National Center for Employee Ownership, *What is Employee Ownership?*, https://www.nceo.org/what-is-employee-ownership.

trillion.[8] These plans cover over 14.2 million participants, of whom 10.6 million are active participants—those currently employed and covered by an ESOP.[9]

ESOPs enjoy bipartisan support. Recently, the Main Street Employee Ownership Act of 2018 (115 S. 2786 and 115 H.R. 5236), which makes employee-owned businesses eligible for certain Small Business Administration guaranteed loans, was passed as part of the John S. McCain National Defense Authorization Act, PL 115-232, August 13, 2018, 132 Stat 1636.[10] In the Senate, it received co-sponsorship from both Democrats and Republicans.[11] Along similar lines, the Job Creation and Worker Assistance Act of 2002 increased the contribution limits of many qualified retirement plans, including ESOPs, and the Small Business Job

[8] National Center for Employee Ownership, *Employee Ownership by the Numbers* (Sept. 2019), https://www.nceo.org/articles/employee-ownership-by-the-numbers.

[9] *Id*.

[10] Steve Dubb, *Historic Federal Law Gives Employee-Owned Businesses Access to SBA Loans*, Nonprofit Quarterly (Aug. 14, 2018), https://nonprofitquarterly.org/employee-owned-businesses-sba-loans/.

[11] *Id*.

Protection Act of 1996 widened the availability of ESOPs by allowing S corporation[12] shareholders to participate.[13]

There are a number of reasons why ESOPs are deserving of this Congressional blessing. Employee ownership increases equitable, broadly distributed employee wealth accumulation, improves corporate performance, and is associated with greater employee retention and job satisfaction. In part because of this, Congress has provided ESOPs with significant tax benefits. For example, ESOPs allow companies to borrow money and repay it in tax deductible dollars,[14] allow certain dividends paid to an ESOP to be deductible,[15] and, pursuant to the Small Business

[12] S corporations have the limited liability of a regular C corporation but do not pay taxes. Instead, all earnings (income and capital gains) are attributed each year on a pro-rata basis to the company's owners. This applies whether the owners actually receive cash distributions or the earnings simply show up on the company's income statement or balance sheet. This means corporate income is taxed at personal tax rates, and no corporate income is taxed twice (as would be the case for dividends paid to owners of a C corporation).

[13] Cong. Research Serv., RS21526, *Employee Stock Ownership Plans (ESOPs): Legislative History* (2003) at CRS-1, https://www.everycrsreport.com/files/20030520_RS21526_7733b590f3007463efa5ee485eb2fe523cdf71da.pdf.

[14] 26 U.S.C. § 404(a)(9)(A) and (B).

[15] *Id*. § 404(k).

Jobs Protection Act of 1996, income attributable to an ESOP in an S corporation is not taxable.[16]

### A. The Data Show That Employee Ownership Is Extremely Effective in Allowing Employees to Build Wealth.

Overall, ESOPs have been strikingly successful in allowing employees to build wealth. For example, data from the U.S. Department of Labor ("DOL") show that ESOPs have robust and consistent rates of return, and in fact have slightly outperformed 401(k) plans.[17] More specifically, the data show that, between 2007 and 2016, the average annual rate of return for ESOPs with 100 or more participants was 5.8%. By comparison, the rate of return for 401(k) plans with 100 or more

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[16] Small Business Job Protection Act of 1996, Pub. L. No. 104-108, § 1316(a)(2) (1996), https://www.congress.gov/104/plaws/publ188/PLAW-104publ188.pdf; *see also* Cong. Research Serv., RS21526, *Employee Stock Ownership Plans (ESOPs): Legislative History* (2003) at CRS-4, https://www.everycrsreport.com/files/20030520_RS21526_7733b590f3007463efa5ee485eb2fe523cdf71da.pdf.

[17] National Center for Employee Ownership, *Recent Research: DOL Data Shows Strong Rates of Return for ESOPs*, Employee Ownership Report at 3 (Jan./Feb. 2020); U.S. Dep't of Labor Employee Benefits Security Administration, *Private Pension Plan Bulletin Historical Tables and Graphs 1975-2017* at 7, 28-30 (September 2019), https://www.dol.gov/sites/dolgov/files/ebsa/researchers/statistics/retirement-bulletins/private-pension-plan-bulletin-historical-tables-and-graphs.pdf.

participants was 5.0% for the same period.[18] The table below presents the year-by-year performance for ESOPs and 401(k) plans from 2007 to 2016:

**TABLE 1.** Aggregate Rates of Return Earned by ESOPs and 401(k) plans, 2007–2016

| YEAR | ESOPS | 401(K) PLANS |
|---|---|---|
| 2007 | 8.2% | 7.6% |
| 2008 | -21.9% | -24.9% |
| 2009 | 15.0% | 18.8% |
| 2010 | 13.2% | 12.0% |
| 2011 | 2.0% | 0.1% |
| 2012 | 11.2% | 11.2% |
| 2013 | 18.9% | 18.3% |
| 2014 | 7.8% | 6.7% |
| 2015 | 1.0% | 0.1% |
| 2016 | 8.5% | 7.6% |
| Standard Deviation | 10.8% | 11.9% |

*Source: Department of Labor, 2016 Private Pension Plan Bulletin*

ESOPs had higher rates of return than 401(k) plans in eight of those ten years.[19] ESOPs also had lower volatility, as measured by the standard deviation, or the

[18] The DOL's data is based on a review of Forms 5500 for 761,140 defined contribution ("DC") plans with 100 or more participants for the 2007-2016 period, or an average of 76,114 DC plans per year. The data is not broken down into ESOPs versus 401(k) plans versus other types of DC plans.

[19] In addition, comparing 2006-07 Form 5500 data for 3,976 ESOPs and 64,165 401(k) plans, "[c]ontrolling for company size, industry and age of plan suggests that total assets per participant are approximately 20% higher in ESOP companies than in companies with non-ESOP DC plans." Loren Rodgers & J. Michael Keeling, *ESOPs as Retirement Benefits An analysis of data from the U.S. Department of Labor*, National Center for Employee Ownership and Employee

dispersion of annual returns relative to the mean annual return. A low standard deviation would indicate that yearly returns tended to be closer to the mean, while a high standard deviation would indicate a wider range in yearly returns. A lower standard deviation is thus indicative of a less risky investment. Over the 2007 to 2016 period, the standard deviation was 10.8% for ESOPs compared to 11.9% for 401(k) plans. Notably, the DOL data show that ESOPs were stricken less severely than 401(k) plans by the Great Recession: in 2008, the crash year, the decline in ESOP asset value was shallower than in 401(k) plans by three percentage points.

Moving beyond retirement wealth, a 2017 report analyzed data from the National Longitudinal Surveys ("NLS") of the Bureau of Labor Statistics[20] to find that, among 5,504 workers sampled, all ages 28 to 34, workers who are employee-owners have 92% higher median household net wealth, 33% higher income from wages, and 53% longer median job tenure relative to workers who are not employee-

Ownership Foundation, Inc. at 3, 14 (Sept. 20, 2010), https://www.nceo.org/assets/pdf/articles/ESOPs-as-Retirement-Benefits.pdf.

[20] The NLS, sponsored by the U.S. Bureau of Labor Statistics, is a nationally representative survey that follows the same sample of individuals from specific birth cohorts over time.

owners.[21] Along similar lines, the research indicates that employee ownership is associated with higher compensation.[22]

As for job stability, ESOP companies again outperformed similar non-ESOP companies. The aforementioned NLS data-based report found employee-owners' median tenure with their current employer was 5.2 years, compared to 3.4 years for non-employee-owners.[23] In addition, the 2018 administration of the General Social

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[21] Nancy Wiefek, *Employee Ownership and Economic Well-Being*, National Center for Employee Ownership at 1 (May 15, 2017), www.ownershipeconomy.org. This report used data from a sample of 5,504 women and men, first interviewed in 1997. *Id.* at 9. All the respondents were ages 28 to 34 when interviewed most recently in 2013. *Id.*

[22] Fidan Kurtulus & Douglas Kruse, *How Did Employee Ownership Firms Weather the Last Two Recessions? Employee Ownership, Employment Stability, and Firm Survival: 1999-2011*, W.E. Upjohn Institute for Employment Research at 115, Tables 5.1, 5A.2 (Jan. 1 2017) (considering the full population of publicly traded companies in the United States spanning 1999-2011, "[E]mployee ownership is linked to 4.0 percent higher compensation in general and a 2.1 percent increase within a firm when employee ownership is added to compensation."); E. Han Kim & Paige Ouimet, *Employee Capitalism or Corporate Socialism? Broad-Based Employee Stock Ownership*, Center for Economic Studies at 3 (Dec. 2009) (based on a sample of 721 ESOP firms, "We find that . . . firms with small ESOPs, defined as those controlling less than 5% of shares outstanding, increase both employee wages and shareholder value."); Peter Kardas, Jim Keogh, & Adria Scharf, *Wealth and Income Consequences of Employee Ownership*, National Center for Employee Ownership at v (1998) (analyzing 102 ESOP companies and 499 randomly selected control companies in Washington state, "[t]he median hourly wage of $14.72 in the ESOP firms was 8% higher than the median hourly wage in the comparison companies.").

[23] Nancy Wiefek, *Employee Ownership and Economic Well-Being*, National Center for Employee Ownership at 4 (May 15, 2017), www.ownershipeconomy.org.

Survey ("GSS")[24] found that the surveyed non-employee-owners were laid off at a rate of 3.7%, versus 0.6% for the employee-owners.[25] Data from public companies show that those with ESOPs provided more job stability in the previous two recessions: companies with no employee ownership plans cut jobs by 3% for each 1% increase in the unemployment rate; companies with ESOPs by just 1.7%.[26]

Turning finally to workplace morale, during the early 1980s, the NCEO conducted an exhaustive investigation of how employees react to being owners.[27] The NCEO surveyed over 3,500 employee owners in 45 companies. It looked at over 20 factors, including company size and industry, employee demographics, the age of the plan, unionization, voting rights, region, and others in an effort to

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[24] The GSS is a nationally representative, face-to-face survey covering a broad range of behavior and attitudes conducted by the National Opinion Research Center ("NORC") at the University of Chicago. Each administration of the survey invites responses from roughly 5,000 eligible Americans. The General Social Survey, NORC at the University of Chicago, https://gss.norc.org/for-survey-participants.

[25] Loren Rodgers, *New Data on Employee Ownership from the General Social Survey*, National Center for Employee Ownership, https://www.nceo.org/employee-ownership-blog/article/new-data-employee-ownership-general-social-survey.

[26] Fidan Kurtulus & Douglas Kruse, *How Did Employee Ownership Firms Weather the Last Two Recessions? Employee Ownership, Employment Stability, and Firm Survival: 1999-2011*, W.E. Upjohn Institute for Employment Research at 60 (Jan. 1 2017) (considering the full population of publicly traded companies in the United States spanning 1999-2011).

[27] Michael Quarrey & Corey Rosen, *How Well is Employee Ownership Working?*, Harvard Business Review (Sept. 1987).

determine whether it mattered to employees that they had stock in their company, and if so, when. The results clearly established that employees favored being owners. The more shares they owned, the more committed they were to their company, the more satisfied they were with their jobs, and the less likely they were to leave.

### B. The Data Show That ESOP Investments Compare Favorably to Other Retirement Investments.

The NCEO conducted a study to estimate the default rates on ESOP loans to evaluate two of the most common criticisms of ESOPs; namely (1) that they are excessively risky; and (2) that appraisals tend to be too aggressive, causing ESOPs to overpay for the shares.[28] Both criticisms suggest not only that returns to ESOPs should be inferior to that of 401(k) investments generally (which the data bely), but also that the default rates on ESOP loans should be high. Here again, however, the loans included in the NCEO's sample undermine this hypothesis. Based on an analysis of 1,232 leveraged ESOP transactions at three large banks, 1.3% of ESOP companies in the sample defaulted on their loans in a way that imposed losses on their creditors for loans in effect between 2009 and 2013 (or an annual rate of 0.2%). The defaults accounted for 1.5% of the total value of the ESOP loan portfolio for

[28] Corey Rosen & Loren Rodgers, *Default Rates on Leveraged ESOPs, 2009-2013*, National Center for Employee Ownership (July 2, 2014), https://www.nceo.org/assets/pdf/Default-Study-full.pdf.

these companies during this period.[29] These default rates seem strikingly low given the economic turmoil of 2008-2011, a period that overlaps with the period analyzed in the study.

The available data also debunk another common criticism, which is that ESOPs are not diversified and therefore carry greater risk. As the argument runs, investments in a single company's stock carry more uncertainty than the same amount of investment in a diverse portfolio, and this risk is compounded when the company is also the investor's employer. Not only do ESOPs outperform 401(k) plans, as explained, *see supra* at 7-9, they also are frequently offered as a benefit in *addition to*, not a substitute for, a more traditional 401(k) retirement plan. For example, one study used Form 5500[30] data to examine plans that filed Forms 5500

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[29] The bank data were only available for defaults imposing losses; the data presented here do not include defaults that resulted in loan restructuring where the loans were ultimately repaid or were being paid on the new schedule.

[30] Employee benefit plans must file a Form 5500 each year "to satisfy annual reporting requirements under the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code." U.S. Dep't of Labor Employee Benefits Security Administration, *Forms and Filing Instructions*, https://www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/reporting-and-filing/forms. An employee benefit plan must report, among other things, the total number of participants, the current value of plan assets and liabilities, and the value of employer and participant contributions. *See* U.S. Dep't of Labor Employee Benefits Security Administration, *Form 5500 Annual Return/Report of Employee Benefit Plan* (2019), https://www.dol.gov/sites/dolgov/files/EBSA/employers-and-advisers/plan-administration-and-compliance/reporting-and-filing/form-5500/2019.pdf; U.S.

in both 2006 and 2007,[31] and that had ESOPs (3,976 plans) or 401(k) plans (64,165 plans). The study found that:

- ESOP companies, by definition, have at least one DC plan: the ESOP. More than half of them (56%) have a second DC plan, likely a 401(k). In comparison, the Bureau of Labor statistics reports that 47% of companies overall have a DC plan. In other words, an ESOP company is more likely to have two DC plans than the average company is to have any.

- ESOP companies contribute substantially more annually to their ESOPs than companies with non-ESOP DC plans contribute to their DC plans: the average ESOP company contributed $4,443 per active participant to its ESOP in the most recently available year. In comparison, the average non-ESOP company with a DC plan contributed $2,533 per active participant to their primary plan that year.

- The average ESOP participant in the average ESOP company has company-sourced DC assets worth 2.22 to 2.29 times as much as the assets held by the average participant in the average company with a non-ESOP DC plan.[32]

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Dep't of Labor Employee Benefits Security Administration, *Schedule H (Form 5500) Financial Information* (2019), https://www.dol.gov/sites/dolgov/files/EBSA/employers-and-advisers/plan-administration-and-compliance/reporting-and-filing/form-5500/2019-schedule-h.pdf.

[31] Loren Rodgers & J. Michael Keeling, *ESOPs as Retirement Benefits An analysis of data from the U.S. Department of Labor*, National Center for Employee Ownership and Employee Ownership Foundation, Inc. at 3, 14 (Sept. 20, 2010), https://www.nceo.org/assets/pdf/articles/ESOPs-as-Retirement-Benefits.pdf; *see also* Loren Rodgers, *Are ESOPs Good for Employees?*, Bloomberg BNA, Pensions & Benefits Daily at 3-4 (Nov. 9, 2010).

[32] *See also* Nate Nicholson, *How Do Employer 401(k) Contributions Change After Establishing an ESOP?*, Employee Ownership Report at 3 (Mar./Apr. 2020) (analyzing 110 companies with an ESOP and a 401(k) plan and finding that "setting up an ESOP tends to be followed by a modest but significant reduction in employer-

Finally, ESOPs have a built-in diversification mechanism. Upon reaching age 55 and 10 years of participation in the plan, participants are entitled by law to diversify out of up to 25% of company stock in their ESOP accounts over the next five years, and in the sixth year they may diversify out of up to a cumulative total of 50% of company stock.[33]

## II. In a Fully Leveraged ESOP Stock Purchase Transaction, a Positive Post-Transaction Equity Value for the ESOP's Stock Shortly After the Transaction Closing Indicates That the Purchase Price Was Favorable to the ESOP.

The Choate ESOP purchased eight million shares, or 80%, of Choate stock for $198 million in December 2016.[34] This transaction was 100% debt-financed: "Choate borrowed $57 million from a bank and then turned around and loaned that $57 million to the Choate ESOP for part of the purchase. To finance the remainder of the purchase, the Choate ESOP issued notes to the selling shareholders for the remaining $141 million at a 4% annual rate."[35]

The use of debt financing to facilitate the Choate ESOP's stock purchase, including the flow of funds from outside lenders to the company, and from the

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side 401(k) contributions, a reduction far outweighed by substantial new employee retirement assets in the ESOP itself.").

[33] 26 U.S.C. § 401(a)(28).

[34] JA312.

[35] *Id.* (internal citations omitted).

company to the ESOP, is nothing out of the ordinary.[36] ESOPs are unique among retirement benefit plans in that they can borrow money. Typically, as was the case here, a lender will make a loan to the company to infuse capital, with the company reloaning the money to the ESOP. The ESOP then may use the loan proceeds to purchase existing shares from current owners, as was the case here. Of course, the ESOP itself does not have any money to repay the loan, so the company makes tax-deductible contributions to the plan that the plan then uses to repay the lender. This means, in effect, the company can take a tax deduction for the principal and interest on the loan, provided applicable requirements are met. In addition, the company can deduct dividends paid on the shares acquired with the proceeds of the loan that are used to repay the loan itself (in other words, the earnings on the stock being acquired help pay for the stock itself).

Where, as here, the ESOP uses debt financing to purchase company stock, the purchase price, which is based on the subject company's enterprise value and capital structure *prior to* the transaction,[37] is independent of the debt financing decision. Put

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[36] Nor is the use of warrants anything out of the ordinary. A 2015 survey of 240 ESOP transactions showed that about 27% of ESOP transactions involve warrants as part of seller notes. National Center for Employee Ownership, *NCEO Original Research: The Transaction Survey*, Employee Ownership Report at 10-11 (Jan./Feb. 2016).

[37] Paul Horn, *Understanding and Communicating ESOP Valuations*, National Center for Employee Ownership at 2 (Apr. 2013) ("A good definition of valuation

another way, it would be inappropriate to adjust the purchase price to account for the debt. Indeed, if it were otherwise, it would frustrate the fair market value standard that is generally applicable to ESOP stock purchase transactions.[38] That standard defines "fair market value" as "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."[39] It is difficult to imagine a "willing seller . . . not under any compulsion to sell" who would agree to lower the purchase price (*i.e.*, to accept a price well below enterprise value) solely for the purpose of easing the debt burden on a buyer that chooses to finance the acquisition through debt. If a hypothetical willing buyer could effectively reduce the purchase price by some or all of the intended debt financing, the debt would be unnecessary. Such behavior would not only contradict the concept of fair market value, but would also violate any rational theory of how a market operates.[40]

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is 'the art of assessing the relationship between an asset's future investment returns and the risk of achieving those returns.' In the case of a business, it is the art of assessing the present enterprise value of the company based on its expected future performance and ability to generate cash.").

[38] 29 U.S.C. § 1108(e); 29 C.F.R. § 2550.408e(d).

[39] Rev. Rul. 59-60, 1959-1 C.B. 237 (1959), https://www.pvfllc.com/files/IRS_Revenue_Ruling_59-60.pdf .

[40] Similarly, if the fair market value of the asset were affected by the buyer's intentions with respect to financing, then a buyer who intended to finance 100% of

Following the transaction closing, the *equity value* of the ESOP's stock is the value of the purchased equity less the transaction debt.[41] The district court correctly recognized the difference between the company's pre-transaction enterprise value and the post-transaction equity value of the stock the ESOP purchased: "The purchase price was $198 million and the Choate ESOP took on $198 million in debt to obtain the stock. The expected value of the Choate ESOP's shares—at least in the short term—would be $0."[42] The court aptly likened the ESOP to a home buyer who "finds a house that is listed at $198,000" but "has no money for a down payment . . . so she obtains a $198,000 mortgage loan in order to buy the house."[43] The "expected" outcome is that "her asset and her corresponding obligation result in $0 in new equity."[44]

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the purchase would be obtaining an asset with a fair market value of zero. This would be an equally irrational result.

[41] *See* Scott S. Rodrick, *An Introduction to ESOPs*, National Center for Employee Ownership at 24 (19th Ed. 2020) ("When a company borrows money to finance a leveraged ESOP transaction (as when the ESOP buys a large block of stock from shareholders), the debt it takes on goes on its balance sheet, thus reducing its value. Thus, immediately after the transaction, the company will be worth less than what the ESOP paid for it . . . . Over time, as the debt is repaid, the value of the company's stock will rebound, all other things being equal.").

[42] JA317.

[43] JA316.

[44] JA316-17.

Significantly here, the post-transaction equity value of the Choate stock was not $0. Instead, it substantially exceeded this "expected" value—just a few weeks after the transaction closed, it was $64.8 million. Thus, "the Choate ESOP actually bought the 8 million Choate shares in December 2016 at a discount (or the shares actually *appreciated* in value, approximately 33%, in less than a month)."[45] In other words, achieving an equity value greater than $0 within a short period of time after the transaction closing is an indicator that the purchase price was not only consistent with the fair market value standard, but also favorable to the buyer. Far from demonstrating injury to the ESOP, the $68 million post-transaction positive equity value indicates that the ESOP purchased the Choate stock at a discount, and thus realized an almost immediate economic benefit from the deal.

## CONCLUSION

For the foregoing reasons, this Court should affirm the judgment of the district court.

[45] JA317 (emphasis in original).

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## CERTIFICATE OF COMPLIANCE

1. This brief complies with the type-volume limitations of Fed. R. App. P. 29(a)(5) and 32(a)(7)(B)(i) because it contains 4,500 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(f).

2. This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using Microsoft Word 2016 in Times New Roman 14-point font.

*/s/ Shannon M. Barrett*
Shannon M. Barrett

**CERTIFICATE OF SERVICE**

I hereby certify that, on this 9th day of June, 2020, I electronically filed the foregoing with the Clerk of the Court using the appellate CM/ECF system. All participants are registered CM/ECF users, and will be served by the appellate CM/ECF system.

*/s/ Shannon M. Barrett*
Shannon M. Barrett

# ADDENDUM

## Appendix A: Major Employee Ownership Studies Meeting Academic Standards

| TYPE OF PLAN | PERFORMANCE MEASURE | STUDY PERIOD | SCOPE OF STUDY | PERFORMANCE IMPACT | SOURCE |
|---|---|---|---|---|---|
| ESOPs, Private Companies | Annual growth post-ESOP relative to pre-ESOP, indexed for comparable company data. | 1982-1986 | Sample of 3,500 employee owners in 45 companies. | During the five years before instituting their ESOPs, the 45 companies had, on average, grown moderately faster than the 238 comparison companies: annual employment growth was 1.21% faster, and sales growth, 1.89% faster.<br><br>During the five years after these companies instituted ESOPs, however, their annual employment growth outstripped that of the comparison companies by 5.05%, while sales growth was 5.4% faster. | Michael Quarrey and Corey Rosen, *How Well is Employee Ownership Working?*, Harvard Business Review (Sept. 1987). |
| Employee Ownership and Millennial Financial Health | Millennials saying they are in employee stock ownership plans report substantially higher income, wealth, and access to benefits than those not in plans. | 2017 | Sample of 5,504 women and men, interviewed from 1997-2013. All the respondents were ages 28 to 34 when interviewed most recently in 2013. | 92% higher median household wealth<br>33% higher income from wages<br>53% longer median job tenure | Nancy Wiefek, *Employee Ownership and Economic Well-Being*, National Center for Employee Ownership (May 15, 2017), www.ownershipeconomy.org. |
| Public Companies with ESOPs Lay People Off Less in Recessions | Public companies with ESOPs provided much more job stability in previous two recessions. | 2017 | The full population of publicly traded companies in the United States spanning 1999-2011. | Companies with no employee ownership plans cut jobs by 3% for each 1% increase in the unemployment rate; companies with ESOPs by just 1.7%. Employee-owned companies were only 78.6% as likely to go out of business as non-employee-owned companies over the 1999-2010 period. | Fidan Kurtulus and Douglas Kruse, *How Did Employee Ownership Firms Weather the Last Two Recessions? Employee Ownership, Employment Stability, and Firm Survival: 1999-2011*, W.E. Upjohn Institute for Employment Research at 60-62 (Jan. 1 2017). |
| Employee Ownership and Layoffs | 2018 General Social Survey. | 2018 | The GSS is a nationally representative, face-to-face survey covering a broad range of behavior and attitudes conducted by the National | Employee-owners are about six times less likely to be laid off with non-employee owners laid off at 3.7% and employee owners at 0.6%. | Loren Rodgers, *New Data on Employee Ownership from the General Social Survey*, National Center for Employee Ownership, https://www.nceo.org/employee-ownership- |

| TYPE OF PLAN | PERFORMANCE MEASURE | STUDY PERIOD | SCOPE OF STUDY | PERFORMANCE IMPACT | SOURCE |
|---|---|---|---|---|---|
| | | | Opinion Research Center at the University of Chicago. Each administration of the survey invites responses from roughly 5,000 eligible Americans. | | blog/article/new-data-employee-ownership-general-social-survey. |
| ESOPs and Employee Compensation | Salaries and retirement benefits compared to comparable employees in comparable companies using all ESOP companies in Washington State and a sample of comparable non-ESOP companies. | 1997 | Sample of 102 ESOP companies and 499 randomly selected control companies in Washington state. | ESOP average hourly wage 12% higher and median hourly wage 8% higher<br>Total retirement assets approx. 2.5 times greater (average value $32,213 compared to $12,735)<br>Diversified retirement assets roughly comparable | Peter Kardas, Jim Keogh, and Adria Scharf, *Wealth and Income Consequences of Employee Ownership*, National Center for Employee Ownership (1998). |
| | Public companies with ESOPs compared to comparable non-ESOP companies. | 1980-2004 | Sample of 721 ESOP firms. | Employee compensation increased for small ESOPs with less than 5% shares outstanding and remained relatively constant for large ESOPs with more than 5% shares outstanding. | E. Han Kim and Paige Ouimet, *Employee Capitalism or Corporate Socialism? Broad-Based Employee Stock Ownership*, Center for Economic Studies (Dec. 2009). |
| | Participation in other retirement plans for ESOP participants; value of company-contributed assets to retirement plans in ESOPs versus non-ESOP companies. | 2004-2007 | 3,976 plans with ESOPs and 64,165 plans with 401(k) plans that filed Forms 5500 with the U.S. Department of Labor in both 2006 and 2007. | ESOP participants are at least as likely to participate in a second retirement plans as comparable non-ESOP participants are likely to be in any retirement plan.<br>Company contributed assets to retirement plans in ESOP companies are 2.2 times greater than company-contributed assets to retirement plans in non-ESOP companies. | Loren Rodgers and J. Michael Keeling, *ESOPs as Retirement Benefits An analysis of data from the U.S. Department of Labor*, National Center for Employee Ownership and Employee Ownership Foundation, Inc. at 3, 14 (Sept. 20, 2010), https://www.nceo.org/assets/pdf/articles/ESOPs-as-Retirement-Benefits.pdf. |
| | Public companies with ESOPs have 4% greater overall compensation. | 1991-2011 | The full population of publicly traded companies in the United States spanning 1999-2011. | ESOPs in public companies had 4% greater overall compensation than public companies without ESOPs. | Fidan Kurtulus and Douglas Kruse, *How Did Employee Ownership Firms Weather the Last Two Recessions? Employee Ownership, Employment Stability, and Firm Survival: 1999-2011*, W.E. Upjohn Institute for Employment Research at 115, Tables 5.1, 5A.2 (Jan. 1 2017). |

| TYPE OF PLAN | PERFORMANCE MEASURE | STUDY PERIOD | SCOPE OF STUDY | PERFORMANCE IMPACT | SOURCE |
|---|---|---|---|---|---|
| | ESOP companies tend to slightly reduce their 401(k) contributions after setting up an ESOP, but their contributions to the new ESOP considerably outweigh this decrease. | 2010-2016 | Sample of 110 companies with standalone ESOPs effective in 2013 that also contributed to a separate 401(k) plan in at least one plan year before or including the year the ESOP was established (2010-2013). Data gathered from U.S. Department of Labor Form 5500 data from 2010 through 2016. | Median 401(k) company contribution dropped $366 after ESOP was set up; median ESOP contribution from company was $4,789. | Nate Nicholson, *How Do Employer 401(k) Contributions Change After Establishing an ESOP?,* Employee Ownership Report (Mar./Apr. 2020). |

PRODUCTIVITY

# How Well Is Employee Ownership Working?

by Corey Rosen and Michael Quarrey

From the September 1987 Issue

Ever since 1974, when Congress enacted the first of a series of tax measures designed to encourage employee stock ownership plans (ESOPs), the number of employee-owned (or partially owned) companies has grown from about 1,600 to 8,100, and the number of employees owning stock has jumped from 250,000 to more than eight million.[1] Employee-owners publish the *Milwaukee Journal,* bag groceries at Publix Supermarkets, roll tin plate at Weirton Steel, and create high-tech products at W.L. Gore Associates. How well are these companies doing?

Underlying worker ownership is a radically democratic, Jeffersonian ideal—one we strongly endorse. Every American wants to own some property, to have a stake. We all want to know that we are working "for ourselves."

we have studied, only one had required wage concessions; managers at the rest said their wage and benefit packages were competitive quite apart from the ESOPs.

By and large, then, ESOPs are started for the purposes Congress intended—such as allowing employees to become owners of profitable, closely held companies when a principal owner retires (such cases account for about half of all plans) or as an additional employee benefit. The typical ESOP owns a 10% to 40% interest in the company, with 10% to 15% of the plans owning a majority. At least one-third of all plans will eventually afford workers the chance to acquire a controlling interest. And companies, public and private, have instituted ESOPs for other positive reasons—to borrow capital, to divest subsidiaries, or simply to buttress a corporate commitment to having workers share in managerial decisions.

## How Do We Judge Performance?

Nearly all previous studies of employee ownership have found that ESOP companies do respectably well.[2] Unfortunately, all these studies look at ESOP companies only *after* the plans have been set up. As a result, it has been impossible to say whether employee ownership is the cause of better corporate performance or simply that the more successful companies were the ones to set up plans in the first place.

We determined to avoid this ambiguity in our research. In 1986, we studied 45 ESOP companies, looking at data for each during the five years before it instituted the plan and the five years after. We might well have simply compared pre-ESOP figures with post-ESOP figures for each company. But this could prove misleading. Suppose the business climate had brightened—which it did for many industries—during the latter five years? Could the gains be credited to ESOPs? You can't tell how the Yankees are doing merely by comparing this year's stats with last year's. You have to consider the team's standing among other American League teams. (Weirton Steel, perhaps the most familiar ESOP company—which we excluded from our study because it could not meet our ten-year requirement—registered impressive gains after adopting its plan in 1984. Were the gains due to an industrywide recovery or to changes within the company?)

We decided to compare the performance of ESOP companies with the performance of other similar companies. The pivotal year remained the one in which the companies' ESOPs took effect. But we were careful to consider company performance in the context of industry trends. Of the ESOP companies we studied, 20 were from an earlier survey for which we had sufficient data; we excluded companies that had had ESOPs from the start. To provide an adequate sample, we looked at an additional 25 companies. We then chose at least five comparison companies for every ESOP company from *Dun & Bradstreet,* for a total of 238. These were comparable to the ESOP companies in terms of business line, size, and, where possible,

location. We excluded from our ESOP sample companies with business line combinations for which there were no comparison companies.

## ESOP Companies Grow Faster

Once we had our two samples, we collected data on sales and employment growth. We then compared the growth rates of each ESOP company with its five or more comparison companies, calculating the differences in performance before and after the ESOP was established.

If an ESOP company's growth was consistent and significantly higher than its comparison companies' growth, we ascribed this to the "ESOP effect." An ESOP company might well have outperformed the comparison companies before it set up its ESOP. We registered an ESOP effect only if the company's performance was even more impressive after it set up its plan.

The results of this analysis proved striking. During the five years before instituting their ESOPs, the 45 companies had, on average, grown moderately faster than the 238 comparison companies: annual employment growth was 1.21% faster, and sales growth, 1.89% faster. During the five years after these companies instituted ESOPs, however, their annual employment growth outstripped that of the

comparison companies by 5.05%, while sales growth was 5.4% faster. Moreover, 73% of the ESOP companies in our sample significantly improved their performance after they set up their plans.

Incidentally, it would obviously have been preferable to judge the performance of ESOP companies by profit, not growth. Failing companies can grow—at least for a while. But most of the companies in our sample have remained closely held, and we knew in advance that unvarnished profit statements would not be available to us. The next best thing, we reckoned, was to look at growth over a sustained period. Again, we looked at only stable companies whose performance we could track for a minimum of ten years.

Finally, we wondered if there might be other factors involved in setting up an ESOP that might account for improved performance—a change in management, perhaps, or an extraordinary use of ESOP tax breaks. We tested for these and other factors and found no relationship.

## Added Value of Participation

The data show that ESOPs exert a positive influence on corporate performance. But the question remains whether any one aspect of employee ownership can be thought the key to higher productivity.

# How Did Employee Ownership Firms Weather the Last Two Recessions?

## Employee Ownership, Employment Stability, and Firm Survival: 1999–2011

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Douglas L. Kruse

2017

W.E. Upjohn Institute for Employment Research
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formance of the employee ownership firms was slightly better than that of other firms. Similarly, studies have found employee ownership to be associated with greater employment stability in a broader sample of U.S. public companies from 1988 to 2001 (Park, Kruse, and Sesil 2004), and in a sample of U.S. closely held companies from 1988 to 1999 (Blasi, Kruse, and Weltmann 2013).

There is some evidence suggesting that employees may exert formal or informal pressures to increase job security in employee ownership firms. For example, a majority of Americans say that if they owned company stock and an outside investor was attempting a takeover, they would not sell, even for twice the market value of the stock (Kruse and Blasi [1999], citing a 1994 EBRI/Gallup poll). This appears to be due to concerns that an outside investor would lay off workers (Kruse, Freeman, and Blasi 2010).

## DATA AND METHODOLOGY

The firm data for this project were drawn from two sources: 1) Standard and Poor's Industrial Compustat database on publicly traded companies and 2) the Form 5500 pension plan data collected by the USDOL. The Compustat data comprise information on firm characteristics including total employment and financial information, while the Form 5500 pension plan data set contains detailed information on employee ownership in ESOPs and other defined contribution pension plans. We matched firm records from the Compustat data and Form 5500 data using each firm's unique IRS Employer Identification Number for the 13 years spanning 1999–2011, resulting in the firm-year panel data set on which all of our analyses are based.

Our data set is composed of the full population of publicly traded companies in the United States. As noted earlier, this data set provides an advantage over data sets drawn from special surveys suffering from small sample sizes and self-selection of respondents. It also allows us to conduct longitudinal analyses in order to help control for unobserved firm-specific effects. Furthermore, the data span a decade when the United States experienced two recessions, in 2001 and 2008, allowing us to examine how employee ownership firms weathered these eco-

nomic downturns relative to nonemployee ownership companies. We also have an array of measures of employee ownership at companies, including the presence of employee ownership through pension programs and ESOPs, and the extent of such employee ownership in terms of total participation and share of the firm owned by workers.

Our goal is to understand whether firms with employee ownership programs exhibit greater employment stability in the face of economic downturns. We examine six different measures of employee ownership within firms in our empirical analyses in particular:

1. **Any employee ownership:** whether a firm reported any employee ownership stock in any of its defined contribution pension plans, including employee ownership in 401(k) plans, ESOPs, and deferred profit-sharing plans in a given year.[3]

2. **ESOP:** whether a firm reported having an ESOP plan in a given year.

3. **Employee ownership stock value per employee at the firm:** total employee-owned stock value in dollars, divided by total number of employees (including nonowners) at a firm in a given year.[4]

4. **Percentage of company owned by employees:** the share of the firm owned by employees in a given year.

5. **Employee owners as a percentage of employees:** the share of all employees participating in employee ownership at a firm in a given year.

6. **ESOP participants as a percentage of employees:** the share of all employees participating in ESOPs at a firm in a given year.

To understand how firms with employee ownership programs respond to economic downturns, we first consider a fairly broad proxy of economic conditions—namely, the unemployment rate. Figure 3.1 illustrates trends in the national unemployment rate during 1999–2011. The recessions starting in 2001 and 2008 are clearly seen in this figure as sustained increases in the unemployment rate (from 3.97 percent in 2000 up to 5.99 percent in 2003, and from 4.62 percent in 2007 up to 9.63 percent in 2010).

**Table 3.2 Amounts of Employee Ownership within Employee Ownership Firms**

| | Low (25th percentile) (1) | Median (50th percentile) (2) | High (75th percentile) (3) | Very high (95th percentile) (4) | Average (5) | Number of firm-year observations (6) |
|---|---|---|---|---|---|---|
| EO assets per employee[a] ($) | 949 | 3,937 | 12,967 | 44,414 | 10,540 | 18,429 |
| EO as % of firm ownership | 0.5 | 1.5 | 3.9 | 11.9 | 3.3 | 17,395 |
| Employee owners as % of all employees | 52.5 | 80.2 | 100.0 | 100.0 | 72.4 | 18,539 |
| ESOP participants as % of all employees | 47.6 | 74.6 | 96.9 | 100.0 | 68.8 | 7,515 |

NOTE: Restricted to years in which firm had positive values of employee ownership. EO = employee ownership.

[a] Calculated across all employees in company, not just participants in employee ownership plan.

SOURCE: Data are from USDOL Form 5500 pension database matched to Standard and Poor's Industrial Compustat data on publicly traded companies in the United States.

specification in which the negative shock measure we use is increased unemployment rate, the second column uses decreased employment-to-population ratio, the third column uses decreased firm sales, and the final column uses decreased stock price.

## Unemployment Rate

Our first set of results, presented in column 1 of Table 3.3, indicates support for our hypothesis that employee ownership firms reduce their employment by a smaller percentage when faced with a negative shock compared to firms without employee ownership.

When the unemployment rate increases by 1.0 percent, firms without employee ownership in any of their defined contribution plans decrease employment by 3.0 percent, while firms with any employee ownership in their defined contribution plans decrease employment by only 2.8 percent, and firms with any ESOPs decrease employment by only 1.7 percent. The second of these differences is strong enough to reject ran-

dom sampling error as an explanation. We see a statistically stronger relationship when we turn our attention to the value of employee ownership stock per employee at the firm: when the unemployment rate increases by 1 percent, firms where the value of employee ownership assets per worker is low (where "low" is defined as being at the twenty-fifth percentile of the distribution) decrease their employment by 2.9 percent, in contrast to firms where the value of employee ownership is at the median (fiftieth percentile), high (seventy-fifth percentile), or very high (ninety-fifth percentile) levels, at which employment declines by only 2.7 percent, 2.0 percent, and 0.6 percent, respectively. Employment declines are only statistically weakly related to the percentage of the firm owned by employees, but they are statistically strongly related to employee coverage: when the unemployment rate increases by 1 percent, firms where the share of workers in employee ownership is zero, low, at the median, and high experience an employment decrease of 3.0 percent, 2.5 percent, 2.3 percent, and 2.1 percent, respectively. Likewise, firms in which the share of workers in ESOPs is zero, low, at the median, high, and very high experience an employment decrease of 3.0 percent, 1.9 percent, 1.3 percent, 0.8 percent, and 0.7 percent, respectively.

**Employment-to-Population Ratio**

As mentioned before, changes in the employment-to-population rate serve as a better measure of economic downturn than the unemployment rate because the latter considers individuals who are not working but are seeking employment, which can be difficult to measure accurately. Therefore, we also estimate all our regressions treating as our indicator of economic downturn a decline in the annual employment-to-population rate rather than an increase in the annual unemployment rate. Figure 3.3 illustrates the trajectory of the employment-to-population rate over the period 1999–2011.

The results summarized in column 2 of Table 3.3, using the employment-to-population ratio, show strong evidence that EO firms provide greater employment security than non-EO firms during economic downturns.

Firms with no employee ownership experience a 4.2 percent employment decline when the employment-to-population rate goes

ferent: new cooperatives have a honeymoon period when commitment is high and risk of closure is lower than that for conventional firms, although risks increase later on (Pérotin 1997).

The Mondragon system of cooperatives in Spain also deserves mention here. The Mondragon Corporation is the largest worker cooperative in the world; it consists of a federation of worker cooperatives in the Basque region of Spain. While there have not been studies focused on survival of individual cooperatives in Mondragon, the survival and growth of the overall system since the 1950s is consistent with the idea that employee ownership can promote survival. The survival of the Mondragon system is undoubtedly enhanced by a supportive infrastructure that includes a university providing graduates and technical assistance to the cooperatives, and a bank providing financial capital and assistance with financial planning.

## DATA AND METHODOLOGY

As described in Chapter 3, we compiled the data set by merging Standard and Poor's Industrial Compustat database on publicy traded firms and the Form 5500 pension plan data collected by the U.S. Department of Labor for the years 1999–2010. The Compustat database provides information on firm characteristics like total employment, industry, financial information, and reason for firm failure, while the Form 5500 pension plan database contains detailed information on employee ownership in defined contribution plans and employee stock option plans (ESOPs). We matched firm records from the Compustat data and Form 5500 data, using each firm's unique IRS employer identification number.

Also as described in Chapter 3, our data set is made up of the full sample of publicly traded companies in the United States, which is an important improvement over data sets drawn from special surveys suffering from small sample sizes and bias from self-selection of respondents. A further advantage is the 12-year span of our data set, covering a decade when the United States experienced two recessions, in 2001 and 2008; this allows us to examine how employee ownership firms weathered these economic downturns relative to nonemployee owner-

ship companies. We also have a rich array of measures of employee ownership at companies, including the presence of employee ownership through pension programs and ESOPs, and the extent of such employee ownership in terms of total participation and the share of the firm owned by workers. One limitation is that firm disappearance is uncommon in general, especially among firms that have gone public. While we have enough disappearances to enable meaningful analysis, the low likelihood of disappearance makes it more difficult to establish significant differences, which makes any significant differences we do find all the more noteworthy. It should also be noted that our results are based on the universe of publicly traded companies over this time period, but that they might not fully generalize to closely held companies, which are generally smaller and have a different industrial distribution.

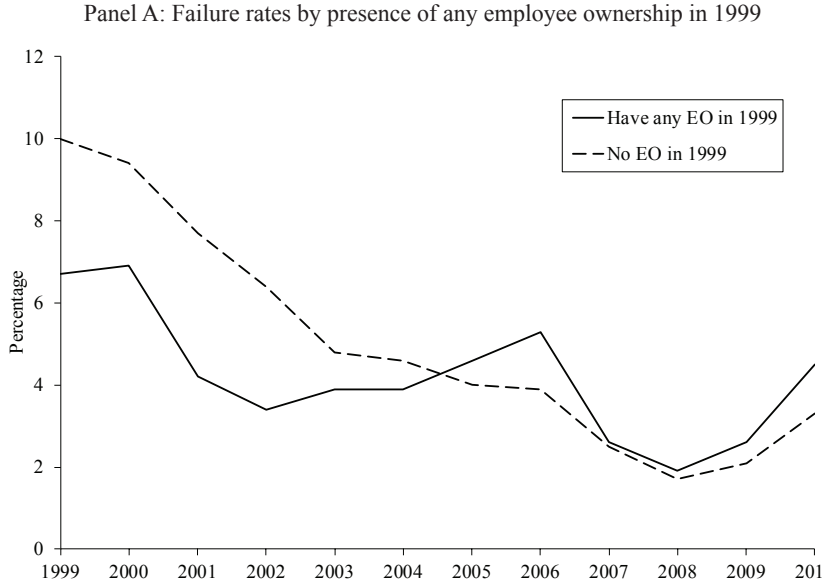
We estimate Cox proportional hazards regressions to predict the likelihood of firm failure.[3] The main independent variable of interest in our hazard models is the employee ownership variable. Our hypothesis is that the relative hazard ratio for this variable should be between zero and one, indicating a lower "hazard" or likelihood of failure for EO firms than non-EO firms, on average. The regressions also include firm controls, including firm size, union status, and industry.

We first estimate regressions in which we treat any disappearance of a firm from the Compustat database as a firm failure. However, companies may disappear as independent entities when they merge or are acquired by another company, and this can actually signal success in some cases, as other firms want to acquire or merge with successful companies. Compustat provides reasons for deletion of firms that no longer appear in that database, including acquisition, merger, bankruptcy, and liquidation. We therefore also estimate models in which firm failure is defined strictly as bankruptcy or liquidation.

As in the analysis of employment stability, we consider six different measures of employee ownership in our empirical analyses: 1) any employee ownership, 2) presence of an ESOP, 3) employee ownership stock per employee, 4) employee ownership—percentage owned, 5) employee owners as a percentage of employees, and 6) ESOP participants as a percentage of employees.

Table 4.1 shows average probabilities of firm disappearance by presence of employee ownership in the pooled analysis sample, and it illustrates that firms with employee ownership programs are less likely

**Figure 4.1 Failure Rates of 1999 Firms by Employee Ownership**




NOTE: Tracks the share of 1,664 firms with "any employee ownership" and 8,242 firms with "no employee ownership," as observed in 1999, that were no longer observed in ensuing years.

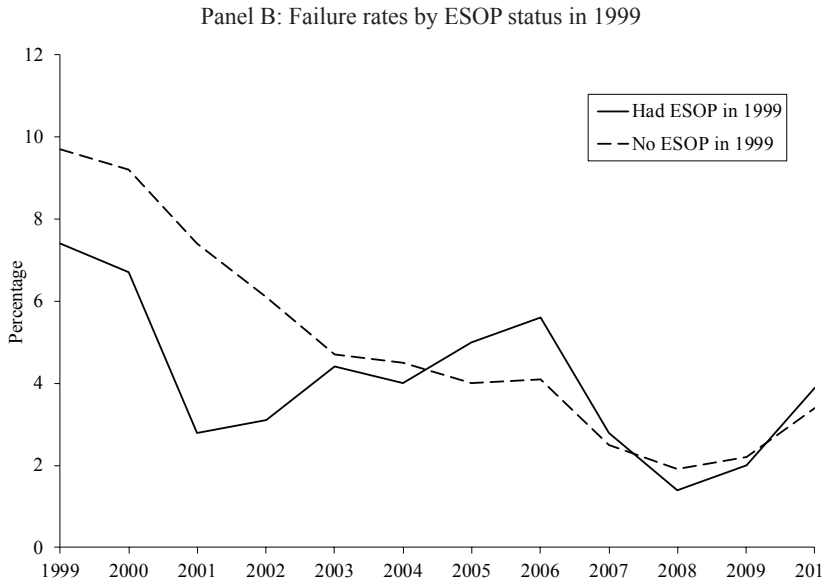
SOURCE: Data are from USDOL Form 5500 pension database, matched to Standard and Poor's Compustat data on publicly traded companies in the United States, 1999–2010.

lar in Panel B for firms with and without ESOPs and in Panel C for firms where the share of the firm owned by employees is above and below 5 percent.

## REGRESSION RESULTS

In Table 4.2, we summarize the hazard ratios from Cox proportional hazard regressions predicting the likelihood of firm disappearance (based on more detailed regression results in Appendix Table 4A.1). For each EO measure, we report the hazard ratios both from the model

**Figure 4.1 (continued)**



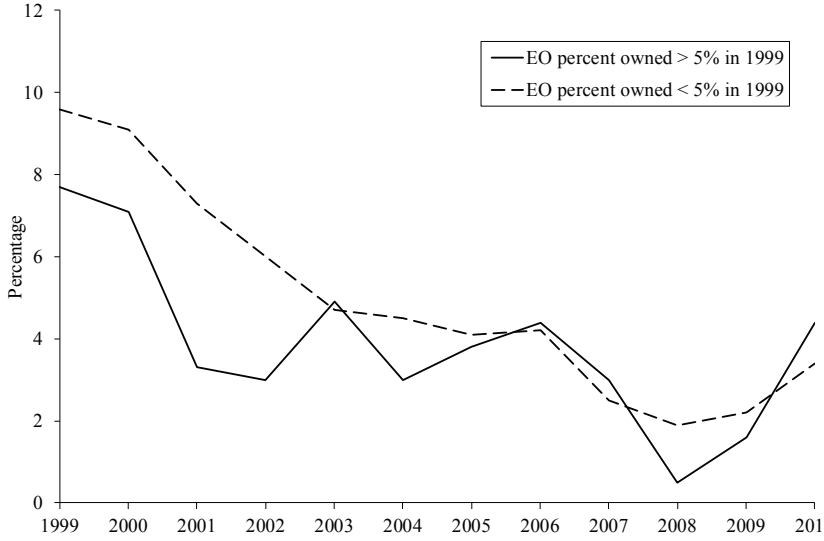

NOTE: Tracks the share of 645 firms with "any ESOPs" and 9,262 firms with "no ESOPs," as observed in 1999, that were no longer observed in ensuing years.

where we treat any disappearance of a firm from the data as a firm failure (column 1) and from the model where we define firm failure strictly as bankruptcy or liquidation (column 2).

Column 1 of Table 4.2 provides strong evidence that EO firms are less likely to disappear than non-EO firms, and the results are statistically significant for all the employee ownership variables in our analysis. As seen in the first entry in column 1, the relative hazard ratio associated with any EO is 0.786 and significant, meaning that EO firms were only 78.6 percent as likely as non-EO companies to disappear in any year over the 1999–2010 period. Second, firms with ESOPs were 82.1 percent as likely as non-ESOP firms to disappear in any year. Third, the value of EO stock per worker was associated with a higher survival probability: an extra $1,000 of employee ownership stock was linked to a 0.5 percent lower risk of disappearing. This means that, since the

**Figure 4.1 (continued)**

Panel C: Failure rates by EO greater than or less than 5 percent of firm




NOTE: Tracks the share of 366 firms with EO percentage of company owned >5% and 9,542 firms with EO percentage of company owned <5%, as observed in 1999, that were no longer observed in ensuing years.

mean value of employee ownership stock among employee owners was $10,613, average employee ownership was linked to a 5.307 percent lower risk of disappearing in any given year. Fourth, the share of the firm owned by employees had a big impact on firm survival: firms where the share of the firm owned by employees was 5 percent or more were only 77.2 percent as likely to disappear as firms with less than a 5 percent share of employee ownership. Finally, the share of workers participating in employee ownership and ESOPs was also negatively related to the likelihood that a firm would disappear: specifically, an increase in the share of the firm's employee owners from 0 percent to 100 percent was associated with a 22.4 percent lower risk of disappearing in any given year, and an increase in ESOP participants at the firm from 0 percent to 100 percent was linked to a 24.4 percent lower risk.

**Table 4.2 Summary of the Relationship between Employee Ownership and Firm Survival from Cox Proportional Hazard Regressions Predicting Firm Survival over the Period 1999–2010**

| | Dependent variable | |
|---|---|---|
| | Disappeared for any reason | Disappeared because of bankruptcy or liquidation |
| Any EO | **0.786** | 0.928 |
| ESOP | **0.821** | 0.900 |
| EO stock per worker | **0.987** | **0.776** |
| EO percentage of company owned >5% | **0.772** | 0.813 |
| Employee owners as % of all employees | **0.776** | 0.800 |
| ESOP participants as % of all employees | **0.756** | 0.512 |

NOTE: Each cell contains the estimated hazard rate from a Cox Proportional Hazard Regression predicting the likelihood of firm death for each EO variable in turn. Full regression results are reported in appendix tables. Each regression controls for firm size, union status, and industry. Bold figures indicate that the hazard estimate is statistically significantly lower than 1.00 ($p < 0.05$).

Turning to column 2 of Table 4.2, using the more stringent firm failure measure of bankruptcy or liquidation, we see that EO firms were less likely than non-EO firms to experience bankruptcy or liquidation in any given year over the 1999–2010 period; however, most of the hazard rates do not achieve statistical significance at the 5 percent level. One important reason for the loss of statistical significance is that the sample size of firms that experienced bankruptcy or liquidation is far smaller than the sample size of those that disappeared from the data set for any reason (only 303 firms over the 1999–2010 period as opposed to 6,100 firms). We therefore are cautious about relying too heavily on this second set of estimates. The only employee ownership measure for which the hazard rate is statistically significant in column 2 is EO stock per worker, which reveals that firms with an extra $1,000 of EO stock were linked to a 22.4 percent lower risk of experiencing bankruptcy or liquidation in any given year during the 1999–2010 period.

To what extent does employment stability mediate or facilitate the positive influence of employee ownership on a firm's likelihood of persisting through negative economic downturns? We investigated whether the positive link between employee ownership and firm survival identi-

As reviewed in Chapter 1, past research indicates that employee ownership tends to come on top of market levels of pay. It is rare for employee ownership to be part of wage or benefit concessions, and studies find that employee ownership firms have average base wages that are as high as, or higher than, those in comparable firms without employee ownership. There is also clear evidence that base pay levels do not generally decrease when ESOPs are adopted in public companies (Kim and Ouimet 2014).

Employee ownership also generally comes on top of standard pay among the firms in our data set. We summarize key results in Table 5.1, with more detail in Appendix Table 5A.2. We present estimates that include comparisons both within and between firms (using random-effect specifications) and only within firms (using fixed-effects specifications). The former comparisons answer the question of how employee ownership relates to compensation levels in general, while the latter comparisons answer the question of what types of changes occur in compensation within a firm when employee ownership is increased or decreased. As can be seen in Table 5.1, employee ownership is associated with higher compensation under either type of comparison. The most telling result is found in column 1 of Table 5.1. If employee ownership substitutes for standard pay, then it should be associated with lower levels of pay, excluding pension contributions. It is not—in fact, nonpension pay is positively linked to employee ownership, with figures indicating between 1.4 and 7.4 percent higher pay across three key measures of employee ownership. Column 2 shows that pension contributions are significantly higher (11.6 percent) in companies with employee ownership, and that they increase by an average of 4.4 percent when companies adopt employee ownership. Combining pension and nonpension data, column 3 shows that employee ownership is linked to 4.0 percent higher compensation in general and a 2.1 percent increase within a firm when employee ownership is added to compensation. These pay differentials are strengthened when shareholder returns are considered part of employee compensation, as shown in column 4.

In sum, there is no support for the idea that employee ownership generally substitutes for standard pay or benefits. Given this, there is no plausible mechanism by which increased pay flexibility under employee ownership can lead to increased stability or survival.

**Table 5.1 Summary of Results on Pay Levels and Employee Ownership (%)**

| | Total nonpension compensation per employee | Total pension contribution per employee | Total compensation per employee | Total compensation plus shareholder returns per employee[a] |
|---|---|---|---|---|
| Average pay difference associated with any employee ownership in firm | | | | |
| Comparing both across and within firms | **3.5** | **11.6** | **4.0** | **4.5** |
| Comparing only within firms over time | 1.4 | **4.4** | **2.1** | **3.7** |
| Average pay difference associated with 100% of employees covered by employee ownership plan | | | | |
| Comparing both across and within firms | **7.4** | **20.7** | **8.8** | **8.3** |
| Comparing only within firms over time | **6.1** | **13.8** | **7.7** | **7.0** |
| Average pay difference associated with mean of employee-owned stock per employee ($10,540) | | | | |
| Comparing both across and within firms | **2.6** | **4.9** | **2.6** | **3.3** |
| Comparing only within firms over time | **2.1** | **1.6** | **2.3** | **2.9** |

NOTE: Based on results from Appendix Table 5A.2. Results for "comparing both across and within firms" are based on random-effects specifications, and results for "comparing just within firms over time" are based on fixed effects. Figures in bold are based on statistically significant differences at the 95% level.

[a] Column 4 is based on smaller sample than column 3, accounting for lower figures in rows 3 and 4.

**Table 5A.2 Pay Levels and Employee Ownership**

| Dependent variable: | Ln(total compensation per employee) | | Ln(pension contributions per employee) | | Ln(total compensation excluding pension contributions per employee) | | Ln(total compensation + EO shareholder returns per employee) | | Ln(pension contributions + EO shareholder returns per employee) | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Random effects | Fixed effects | Random effects | Fixed effects | Random effects | Fixed effects | Random effects | Fixed effects | Random effects | Fixed effects |
| | | | | | Panel A | | | | | |
| Any EO | 0.039*** | 0.021* | 0.110*** | 0.043** | 0.034*** | 0.014 | 0.044*** | 0.036** | 0.288*** | 0.111*** |
| | (0.012) | (0.012) | (0.015) | (0.018) | (0.011) | (0.012) | (0.015) | (0.017) | (0.020) | (0.027) |
| Number of firm-year obs. | 14,626 | 12,619 | 52,619 | 45,527 | 14,334 | 12,356 | 12,157 | 10,286 | 42,282 | 35,753 |
| Number of firms | 2,007 | 1,888 | 7,092 | 6,772 | 1,978 | 1,861 | 1,871 | 1,750 | 6,529 | 6,088 |
| | | | | | Panel B | | | | | |
| Average EO stock per employee | 0.002*** | 0.002*** | 0.005*** | 0.001** | 0.002*** | 0.002*** | 0.003*** | 0.003*** | 0.030*** | 0.027*** |
| | (0.000) | (0.000) | (0.001) | (0.001) | (0.000) | (0.000) | (0.000) | (0.000) | (0.001) | (0.001) |
| Number of firm-year obs. | 14,568 | 12,561 | 52,494 | 45,405 | 14,280 | 12,303 | 12,111 | 10,241 | 42,202 | 35,674 |
| Number of firms | 2,007 | 1,887 | 7,089 | 6,769 | 1,977 | 1,859 | 1,870 | 1,748 | 6,528 | 6,083 |
| | | | | | Panel C | | | | | |
| % of employees with EO | 0.084*** | 0.074*** | 0.188*** | 0.129*** | 0.071*** | 0.059*** | 0.080*** | 0.068*** | 0.363*** | 0.127*** |
| | (0.015) | (0.016) | (0.020) | (0.023) | (0.014) | (0.015) | (0.018) | (0.020) | (0.026) | (0.035) |
| Number of firm-year obs. | 13,582 | 11,593 | 49,952 | 42,909 | 13,291 | 11,331 | 11,211 | 9,361 | 40,283 | 33,807 |
| Number of firms | 1,989 | 1,853 | 7,043 | 6,676 | 1,960 | 1,826 | 1,850 | 1,714 | 6,476 | 5,967 |

# WEALTH AND INCOME CONSEQUENCES OF EMPLOYEE OWNERSHIP

## A COMPARATIVE STUDY FROM WASHINGTON STATE

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ADDENDUM 24

**Wealth and Income Consequences of Employee Ownership**
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## Executive Summary

This study attempts to answer questions about the success of companies with employee stock ownership plans (ESOPs) in getting more wealth and income into the hands of employees. By comparing retirement assets and wages in Washington State ESOP companies with those in matched similar non-ESOP firms, the analysis shows that ESOP companies provide significantly higher retirement benefits than comparison firms. The average value (per participant) of all retirement benefits in ESOP companies (in 1995) was approximately $32,000, whereas the average value in the comparison companies was about $12,500. None of the independent variables in the analysis eliminated or significantly diminished the ESOP as an explanation for higher asset values. A large percentage of comparison companies (between 58% and 71%) had no retirement plan at all, and in those that did, employee participation rates in the plans were lower than in the ESOP companies.

Furthermore, companies with ESOPs contributed on average about 10% of pay to all retirement plans, while the comparison companies contributed on average about three percent. Whereas in those comparison companies that have retirement plans, approximately 70% of the value of the assets was in stock offered through 401(k) plans (and presumably diversified), in ESOP companies about 60% of retirement assets take the form of company stock.

The company stock held in the ESOP does not appear to come at the cost of wages. The median hourly wage of $14.72 in the ESOP firms was 8% higher than the median hourly wage in the comparison companies. At the 10th percentile of wages, hourly wages were 4% higher in the ESOP companies, while at the 90th percentile, ESOP company wages were 18% higher. Therefore, the ratio between the 90th and 10th percentiles was higher in the ESOP companies than in the comparison firms. Unions, in both ESOP and control companies, had the effect of raising wages at the 10th percentile and lowering them at the 90th, with the result that median wages for unionized control companies are significantly higher than for non-union controls. On average, the ESOP firms in this study provide a significantly higher total compensation to their employees than do their competitors, but the ratio of 90th to 10th percentile wages suggests that they do so within the framework of rewards already established in the economy.

### About the Authors

Peter Kardas has worked with unions, workers, and businesses in Washington State on economic development, employee ownership, and worker participation projects. Adria Scharf is an associate with Ownership Associates, a consulting firm, and is the director of the Richmond Peace Education

## Introduction

In writings during the 1950s and 1960s, Louis Kelso argued that ownership by employees of company stock is necessary to create a society in which affluence is broadly shared and extremes of economic inequality reduced. If the ultimate goal of employee stock ownership is to achieve a society that has both greater equality of economic condition as well as equality of opportunity for economic gain, then it may be of interest to examine the distribution of wealth and wages in companies that have established employee stock ownership plans (ESOPs) using the tax incentives that Kelso helped inspire. Decades after the establishment of ERISA, have ESOPs lived up to their promise to share more broadly the gains of stock ownership? What are the financial benefits of ESOPs to company employees and to ESOP participants?

The study reported here begins to address these questions with data on wages and retirement plan assets in Washington State companies. We combine government wage data on ESOP companies and comparison companies with retirement plan information from a survey of those companies and from Internal Revenue Service (IRS) Form 5500 filings to estimate:

- How the value of retirement assets in ESOP companies compares to the value of retirement assets in other companies;
- How wages in ESOP companies compare to wages in comparable non-ESOP companies;
- How ESOP and control companies compare on the provision of other benefits, such as health care insurance; and
- Whether the distribution of wealth and wages is more egalitarian in the ESOP companies.

In addition, we investigate the effects of a number of independent variables, including company size, industrial sector, percentage of ownership by the ESOP, years that the plan has been in place, unionization, and company participation programs.

## Methodology and Description of Companies

### The Sample

The sample of 102 ESOP companies includes nearly every such company in Washington State that we were able to identify. We used Form 5500 data and records from the Washington State Employee Ownership Program to generate a list of all definite and potential ESOP companies in the state. We then

made phone calls to those companies to confirm whether they have an ESOP or a KSOP (i.e., a combined 401(k) plan and ESOP).[1]

The 499 control companies were selected by random match. For each employee stock ownership company confirmed to have an ESOP, three to seven control companies of the same employment size and industrial sector (based on the four-digit Standard Industrial Classification [SIC] code) were randomly selected from a database of all companies in the state provided by the Washington State Employment Security Department. All but three ESOP companies were matched with between three and seven controls. For three ESOP companies, there were only two possible comparison companies of the same sector available. This resulted in an average number of control companies per ESOP company of five.

Wage and employment data for 1995 for all 601 companies—102 ESOP companies and 499 matched controls—were obtained from the Employment Security Department. Wages included all gross wages[2] for employees covered by unemployment insurance.[3] Tables 1 and 2 show the distribution of companies in the wage data sample by size and industrial sector, with a column included in each table for the distribution of ESOPs nationwide. A comparison of the nationwide and Washington State data indicates that the Washington companies are fairly representative of other ESOPs in terms of size and industrial sector, except that there is a smaller percentage of companies in Washington with over 500 employees.

## The Survey

We sent surveys to all 601 companies and made follow-up phone calls to 400 of those, obtaining usable responses from 148 companies—47 companies with ESOPs and 101 comparison companies (see the appendix for a copy of the survey). Out of these usable responses, we were able to match up 37 ESOPs with 68 control companies. From survey respondents we have detailed information on the value of assets held by retirement plans, the formula by which benefit assets are allocated to employees, and the number of employees in different wage categories covered by each benefit plan. In addition, survey respondents were asked the value of salary and non-salary compensation for highly compensated employees who are not covered by unemployment insurance, whether the company is public or private, whether its employees are covered by a collective bargaining agreement, the company's age, the types of participatory management techniques used, and the degree of employee influence in various decision-making areas. For ESOP companies, the survey asked for information about the ESOP plan, including the percentage of company stock held in the ESOP trust, the percentage of payroll contributed to the plan in 1995, the basis on which stock is allocated to

row 2 to take into account those comparison companies that do not have plans. Assuming that the figure for control companies should be $12,500 (close to the sum of average assets number from the survey), the weight would be approximately 0.6 ($12,500 ÷ $21,020). In all analyses in the report using 5500 data, control company responses for the second measure of assets (total of all assets divided by the sum of participants) will be weighted by 0.6.

### Interpreting the Results

The numbers in table 5 indicate that the average value of assets per participant is significantly higher in the ESOP companies than in the controls. Looking at the first two columns, representing data from the surveys, we see that the average value in the ESOP companies is $32,213, while the average value in the control companies is $12,735. The composition of the numbers differs significantly as well. For the typical ESOP participant, the ESOP represents 75% of the combined asset value of his or her retirement accounts. Of the 75% that the ESOP holds, 80% is in company stock,[9] meaning that 60% (.75 × .80) of the asset value represented by the ESOP is in company stock. Of the remaining value in the typical ESOP participant's retirement accounts, 12% is from 401(k) assets, 4% from defined benefit assets, and 2% from profit sharing plans. In the control companies, 70% of the value of the assets is from 401(k) plans, while 3% is from defined benefit plans and 11% from profit sharing plans. So while the value of the ESOP company assets is approximately $20,000 higher than the value of the control company assets, the ESOP investment is heavily concentrated in the stock of the employing company and thus carries more risk. On the other hand, the diversified piece of the ESOP participant's retirement assets (40% of 32,000) is almost identical to the total assets of non-ESOP participants.

What do these per-participant assets mean to employees at different wage levels? Looking at ESOP companies that allocate stock to employee accounts either on the basis of payroll (28 out of the 40 companies for which we have data) or payroll to a cap (another 5 companies, for a total of 33 out of 40 who responded),[10] we can calculate a number representing assets per participant per wage category.[11] The results in table 8 should be taken as suggestive only, since we are estimating what the value is of assets per employee in each company—we do not know the actual number. Furthermore, the value for the wage category between $6.01 and $10 an hour is out of line with the other wage categories, indicating that something unusual may be going on in a few companies. Also, the number for each wage category is derived from the sum of values for the various plans, and we cannot be sure that assets for the 401(k) plan, defined plans, and so on are allocated

**Table 11. Assets per Participant, Union and Nonunion Companies**

| Assets per Participant | ESOP Companies With Unions | ESOP Companies Without Unions | Control Companies With Unions | Control Companies Without Unions |
|---|---|---|---|---|
| Assets per participant, survey data | $23,612 ($n = 6$) | $33,877 ($n = 31$) | $87,498 ($n = 7$) | $6,052 ($n = 61$) |
| Assets per participant, 5500 data | $21,990 ($n = 9$) | $33,542 ($n = 57$) | $15,315 ($n = 12$) | $12,280 ($n = 122$) |

*Note:* Using survey data, the difference between union and nonunion companies, ignoring ESOP vs. control, is significant at the .001 level. The difference between ESOPs and controls for survey data is significant at the .05 level. The difference between the union and nonunion controls in the top row of this table is significant at the .0000 level. Using Form 5500 data, the difference between ESOP and controls is significant at the .0000 level.

**Table 12. Assets per Participant for SIC Codes 2 and 3**

| Assets per Participant for: | ESOP Companies With Unions | ESOP Companies Without Unions | Control Companies With Unions | Control Companies Without Unions |
|---|---|---|---|---|
| SIC Codes 2 & 3 5500 Data | $30,274 ($n = 6$) | $23,220 ($n = 13$) | $14,758 ($n = 11$) | $11,047 ($n = 33$) |

rates in the data from the 5500 forms, though table 12 indicates that there is still a difference between union and nonunion control and ESOP companies in SIC codes 2 and 3 (though the difference is not statistically significant). According to the regression analysis summarized in table 13, the presence of an ESOP increases per participant asset value by $20,298.72 when sector, company size, and unionization are held constant. The presence of a union does not have a statistically significant effect on asset values.

What is the effect of majority ownership? The average value of assets per participant for 12 majority-owned ESOP companies is $30,694 using the survey data or $36,369 using the 5500 data, while the average value for 21 minority-owned ESOP companies is $37,000 using the survey data or (for 19 companies) $42,632 using the 5500 data. In either case the difference is around $5,600. But while the majority-owned companies appear to fare worse than those that are minority-owned, their per-person asset values are still significantly higher than the values of their matched controls, as can be seen in table 14.

higher average asset values than less participatory ESOPs, 5500 data indicated the opposite. With both data sources, more participatory control companies had higher asset values than less participatory controls. As with wage data, company size is negatively correlated with asset values, as is the mean start date for companies' retirement plans.

## Wages

Given that the value of retirement benefits is significantly higher in ESOP companies than in comparison companies, do employees at ESOP companies typically take lower wages to make purchase of company stock possible? The simple comparison of means summarized in table 16 suggests otherwise. Here, mean and median wages, wages at the 10th and 90th percentiles, and the ratio between wages at the 90th and 10th percentiles are presented for ESOP companies and their matched controls. The results show that ESOP companies pay both higher average as well as higher median wages. The average ESOP company wage of $19.09 is 12% higher than the average control company wage of $17, and the median ESOP company wage of $14.72 is 8% higher than the median control company wage of $13.58. At the 10th percentile, wages in the ESOP companies are 4% higher than in the controls. Chance cannot be ruled out as an explanation for the differences in the mean, median, or 10th percentile wages. At the 90th percentile, ESOP wages are 18% higher than comparison wages, causing

**Table 16. Hourly Wages for ESOP and Control Companies**

| Hourly Wage | ESOP Companies | Control Companies |
|---|---|---|
| Mean hourly wage | $19.09 ($n = 90$) | $17 (weighted $n = 90$) |
| Median hourly wage | $14.72 ($n = 90$) | $13.58 (weighted $n = 90$) |
| Hourly wage at 10th percentile | $8.85 ($n = 90$) | $8.47 (weighted $n = 90$) |
| Hourly wage at 90th percentile | $30.91 ($n = 89$)* | $26.12 (weighted $n = 89$)* |
| Ratio of 90th to 10th percentile (average of all companies) | 3.49 ($n = 89$) | 3.15 ($n = 89$) |

*Note:* Results for the control companies are weighted so that the sum of control companies for each ESOP company equals one, thus eliminating the bias that results from there being more controls for some ESOP companies than for others. Companies included in the table are all but one of the ESOP companies in the Washington State Employment Security Department's database for which we have at least one match, plus, of course, the matches themselves. (One ESOP company was eliminated because it had a median hourly wage of $96, more than four times the median wage for its matched controls. Two others were removed because the companies only reported wages for the employees, not hours worked, thus making it impossible to calculate wages per hour.)

*$p < .1$

# EMPLOYEE CAPITALISM OR CORPORATE SOCIALISM?

## BROAD-BASED EMPLOYEE STOCK OWNERSHIP

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Abstract

How employee share ownership plans (ESOPs) affect employee compensation and shareholder value depends on the size. Small ESOPs, defined as those controlling less than 5% of outstanding shares, benefit both workers and shareholders, implying positive productivity gains. However, the effects of large ESOPs on worker compensation and shareholder value are more or less neutral, suggesting little productivity gains. These differential effects appear to be due to two non-value-creating motives specific to large ESOPS: (1) To form management-worker alliances ala Pagano and Volpin (2005), wherein management bribes workers to garner worker support in thwarting hostile takeover threats and (2) To substitute wages with ESOP shares by cash constrained firms. Worker compensation increases when firms under takeover threats adopt large ESOPs, but only if the firm operates in a non-competitive industry. The effects on firm valuation also depend on the strength of product market competition: When the competition is strong (weak), most of the productivity gains accrue to employees (shareholders). Competitive industry also implies greater job mobility within the industry, enabling workers to take a greater portion of productivity gains.

JEL classification: G32, M52, J54, J33

Keywords: ESOPs, Employee Incentives, Worker Wages and Compensation, Product Market Competition

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Broad-based employee share ownership (ESO) is an important economic phenomenon. According to the 2006 General Social Survey,[4] 18% of U.S. workers surveyed reported owning company stocks of their employer (Kruse, Blasi and Park 2009). The two most common types of ESO plans are Employee Stock Ownership Plans (ESOPs) and 401-K plans with employer stocks. According to the National Center for Employee Ownership, in 2007, nearly 14 million employees participated in 9,650 ESOPs, with combined assets over $925 billion at public and private firms. The corresponding numbers for ESO through 401-K plans are seven million participants with $275 billion in assets. Both of these plans show an increasing long-term trend; the NCEO estimates the number of participants in ESOPs was one-quarter million in 1975, five million in 1990, and about 14 million in 2007. ESO through 401-Ks has also become increasingly popular since the 1990s.

Previous studies have documented worker productivity increases following adoption of ESO or employee profit sharing plans (Jones and Kato, 1995; FitzRoy and Kraft, 1987; and Beatty, 1995). The finance literature also shows positive stock price reactions to the announcement of ESOP adoptions that are not implemented under takeover pressure (Gordon and Pound, 1990; Chang and Mayers, 1992; Chaplinsky and Niehaus, 1994; and Beatty, 1995). However, there is little evidence on how ESO plans affect employee compensation.

The effect on employee compensation is an important issue. It has an obvious employee welfare implication. Moreover, any change in employee compensation has implications for firm valuation and shareholder value. A typical ESO bestows not only

[4] The General Social Survey is conducted by the National Opinion Research Center of the University of Chicago.

cash flow rights, but also voting or other forms of control rights to employees. As the size of ESO increases, greater cash flow rights may lead to greater productivity gains through improved team effects and collective employee behavior (Kruse, Freeman and Blasi, 2009). However, employee control rights will also increase, which may affect corporate governance and employee compensation. It is not clear how greater cash flow and control rights jointly affect productivity gains and the division of the gains between employees and shareholders. This paper conducts an empirical investigation of how ESOPs affect employee compensation and shareholder value, and by implication, the size of the economic pie.

The data on employee compensation is obtained from a unique establishment-level database maintained by the Center for Economic Studies at the U.S. Bureau of Census. An establishment is any facility with a separate physical address, such a plant, a retail store, a restaurant, and so on. The regression estimates on wages control for establishment fixed effects, year fixed effects, state-year mean wages, industry-year mean wages, establishment age, and other firm-level variables. Panel regressions are estimated using all treatment firms and a control group matched by size, average firm wage, and trends in wage changes prior to the ESOP initiation.

We find that that firms with small ESOPs, defined as those controlling less than 5% of shares outstanding, increase both employee wages and shareholder value. We infer from this evidence that employee capitalism works in the case of small ESOPs; they increase worker productivity and the gains are shared by employees and shareholders. In contrast, large ESOPs with employee share ownership greater than 5% seem to have

more or less neutral effects on both employee compensation and shareholder value, implying little productivity gains associated with large scale employee ownership.

To explain why the size of ESOPs makes such a difference, we investigate two non-mutually exclusive hypotheses specific to large ESOPs: (1) Large employee control rights permeate corporate socialism, negating potential productivity gains and (2) Some large ESOPs are used as a means to substitute cash wages with stock by cash-constrained firms.

A specific form of corporate socialism that is particularly relevant to large ESOPS is management-worker alliance in which management intentionally bestows substantial control rights to employees by implementing large scale ESOPs. This alliance hypothesis is based on the Pagano and Volpin (2005) model in which managers concerned with hostile takeover threats bribe workers with above-market wages in return for their cooperation in fending off hostile bids. Large ESOPs can be effective in protecting incumbent management against hostile takeover threats. Chaplinsky and Niehaus (1994) document the probability of successful takeover dropping by nearly 50% when the target firm has an ESOP in comparison to firms without ESOPs. We hypothesize that if ESOPs are adopted to form management-worker alliance, workers will be rewarded with higher compensation.

To test the alliance hypothesis, we focus on firms operating in concentrated industries. Management-worker alliance represents employee entrenchment; as such, its sustainability requires corporate slack. When firms operate in a highly competitive industry, survival requires efficiency, leaving little slack. Such firms are forced to practice good governance, which is less compatible with employee entrenchment.

constrained firms. Thus, we expect these ESOPs to be associated with less productivity gains.

## II. Data

Our data on ESOPs cover US public firms from 1980 through 2001. This data is hand-collected. We first identify firms with ESOPs, using the Factiva news database. For each year, we search Factiva using the terms "ESOP" and "employee stock ownership plan." We read all articles and note the first date a firm is mentioned as having an ESOP. We identify 756 unique public firms with ESOPs over the sample period. Of these firms, we drop 35 firms with total assets less than $10 million in 2006 dollars. The lack of press coverage on such small firms makes it likely that we missed other similar-sized firms with ESOPs, wrongly identifying them as non-ESOP firms. This potential error is important as our control group is derived from firms in Compustat without identified ESOPs.

With the remaining 721 ESOP firms, we run additional Factiva searches using the firm's name and "employee stock" to locate further information on each firm's ESOP.[7] When available, we record information on the ESOP initiation date.[8] We are able to identify the year of the ESOP initiation for 418 unique firms.

We determine the size of ESOPs by reading annual proxy statements for all firms with ESOPs. In most cases, ESOP share ownership is reported only if the plan has more

[7] In a few cases, this additional search led us to identify the presence of an ESOP in an earlier year. We exclude these observations to prevent a possible survivorship bias. Information about an ESOP may not have been discovered in our first search process if the firm was small and received limited press coverage. When the firm becomes more profitable and grows larger, press coverage becomes more likely, increasing the probability we observe the ESOP. This could cause a positive correlation between observed ESOPs and firm performance.

[8] If a firm underwent a bankruptcy or was dropped from Compustat for a year or more, we assume the ESOP was terminated unless other information is present.

than 5% of the firm's common equity. We assume the ESOP controls less than 5% of the firm's outstanding shares if the proxy statement does not report specific numbers concerning ESOP size. The ESOP database is then matched to Compustat and Center for Research in Security Prices (CRSP) databases for accounting and stock market variables.

The ESOP database is also matched to the Longitudinal Business Database (LBD), a panel data set that tracks all U.S. business establishments with at least one employee or positive payroll from 1975 to the present, maintained by the U.S. Bureau of Census. The database is formed by linking years of the Business Register (formally called the standard statistical establishment list or SSEL.) The Business Register is a Census Bureau construct based primarily on information from the Internal Revenue Service of the U.S. Treasury Department.[9] The Business Register contains information on the number of employees working for an establishment and total annual establishment payroll. The LBD links the establishments contained in the Business Register over time and can be matched to Compustat using a bridge file provided by the US Census.

This Census data is an improvement over the wage and employment data reported in Compustat. For one, the Census data is available at the establishment level which allows us to identify changes at one specific facility as opposed to having to rely on firm-level data. Second, we are able to observe the state of location for each facility. This allows us to control for geography-dependant mean wages. Finally, many active firms in Compustat do not report the number of employees or their compensation. Wage data based on Compustat is unreliable because personnel information is subject to looser reporting and auditing requirements than financial variables.

[9] See Jarmin and Miranda (2002) for more information.

We add to our ESOP sample a set of control firms, matched to our ESOP firms. For each ESOP firm, we calculate 1) total assets, 2) the average firm-level wage per employee, and 3) the change in average firm-level wage per employee prior to the ESOP initiation. The change in wages is used to ensure that the set of ESOP firms and matched firms exhibit a similar trend in wages prior to the year of matching. The change in wages is defined as $(wages_{t-1} - wages_{t-2})/wages_{t-2}$, where t is the year of ESOP initiation.

We estimate the same variables for a set of potential control firms, which includes all firms in the same industry, in the same year that never issued an ESOP. We estimate the absolute difference between the potential control firm and the ESOP firm on all three criteria. We sum up these differences and the control group is chosen as those firms with the smallest total differences. We identify the three nearest neighbor matches for each ESOP firm. However, since we identify the match for each ESOP firm from the same pool of firms, in some cases, a control firm is matched to multiple ESOP firms. To maintain a sample of independent observations, we require a match firm appear in the control group as a unique firm.

ESOP firms are included in our sample for the five years before and the ten years after the ESOP is initiated. We begin five years prior to the ESOP adoption to capture the most current information and extend to ten years afterward because ESOP shares must be granted to individual employee accounts within ten years. Observations after 10 years are excluded to reduce the impact of changes unrelated to the ESOP occurring well after the initiation. We also exclude observations after an ESOP termination to ensure that our baseline is not picking up post-termination effects. [10] The same time series is calculated

[10] There are 56 ESOP terminations (138 plant-year observations) in our ESOP database. Terminating an ESOP is a complex legal procedure. The firm must be able to legally justify why the ESOP was value-

for the matched group. We keep matched firms in our sample for the 5 years before and the 10 years after the match.

Table 1, Panel A, lists the number of new ESOP adoptions and observation counts in our ESOP database by year. It identifies 5,596 firm-year observations between 1980 and 2004 with the median ESOP having 5.93% of shares outstanding.[11] Of the 418 ESOPs in our sample, 225 achieve a size of 5% or greater at some point during their lifetime. The median and the mean ownership of these large ESOPs is 12.18% and 16.65% of shares outstanding, respectively.

Panel B of Table 1 provides summary statistics of the relevant firm level variables. The first column details firms which will later initiate an ESOP, but in the years before the ESOP is initiated. The second column describes firms with ESOPs. The third column details firms with large ESOPs. An ESOP is considered large if, at any point during the lifetime of the plan, it has more than 5% of the outstanding common shares. We choose this demarcation point because proxy statements only detail the size if the ESOP has more than 5% of the firm's equity. In addition, 5% is often used as a threshold for various disclosure requirements, presumably because it signifies an important source of control rights. The fourth column summarizes the set of matched firms.

ESOP firms are more profitable and have higher leverage as compared to control firms. Furthermore, ESOP firms are larger and valued lower as measured by (industry-adjusted) Tobin's Q. The lower valuation is most noticeable for large ESOP firms.

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increasing for the firm in the past but is now value-decreasing; otherwise, it is open to lawsuits from ESOP holders and shareholders. Thus, it is more common to "freeze-out" an ESOP. A freeze-out is usually not announced officially and thus is hard to identify. In our sample, firms which are electing to freeze-out their ESOP will still be recorded as having an ESOP, which is literally true because the ESOP still exists. There are some firms that have rolled up their ESOP into a 401-K plan. Such 401-K plans may still be recorded in our database as an ESOP, which is not completely off-base because they still represent ESO.

[11] We cannot estimate the mean due to missing data on ESOP size for ESOPs with percentage share ownership less than 5%.

Financial leverage increases following ESOP initiation because they are often debt financed.

Panel C of Table 1 provides summary statistics of relevant payroll information at the establishment-level. As mentioned earlier, an establishment describes any facility with a separate physical address, such a factory, service station, restaurant, and so on. We include all establishments owned by either our ESOP group or the control group. Both pre-ESOP firms and ESOP firms have more employees per establishment than the control group. Wages are higher at pre-ESOP firms relative to the control sample and the difference between these firms is magnified post-ESOP.[12]

## III. Empirical results

In this section we first estimate the relation between employee compensation and the presence of ESOPs, followed by an investigation of the relation between firm value and accounting performance and ESOPs.

### *A. Employee compensation*

Our compensation data provides establishment-level annual payroll, which includes all taxable forms of compensation, such as salaries, wages, commissions, and bonuses. However, the compensation data does not include ESOP shares given to employees and, hence, underestimates the total compensation and benefits given to employees with ESOP shares. Our measure of wages per employee is the ratio of annual payroll (in thousand dollars, normalized to 2006 dollars) to the number of employees.

#### A.1. Univariate Analysis

[12] While the difference in wages per employee is more modest between pre-ESOP firms and the control sample, the difference of $829/employee is still statistically significant.

In columns 7 and 8, we repeat our tests using a measure of operating profits as the dependent variable. Unlike Tobin's Q, the profit variable, measured by industry-adjusted operating income divided by total assets, is an accounting based variable that provides an alternative measure of firm performance. The results are consistent with our evidence using Tobin's Q, firm operating performance increases following the adoption of a small ESOP and is essentially flat following the adoption of a large ESOP.

*C. An Interim Summary*

Our results so far suggest that small ESOPs, defined as those controlling less than 5% of shares outstanding, increase both employee wages and shareholder value. We infer from this evidence that small ESOPs increase worker productivity and the gains are shared by employees and shareholders. Large ESOPs, by contrast, increase neither employee wages nor shareholder value. Although the total effects on employee compensation and benefits may be positive if we include the value of ESOP shares granted to employees, the results for large ESOPs suggest much more modest productivity gains. Why the size makes such a difference is the puzzle we attempt to resolve in the next section.

*D. Alternative Motives for Large ESOPs*

There are two possible explanations for the puzzle. The first is that giving too much control rights to workers negates the potential productivity gains arising from improved team effects and collective employee behavior arising from employee ownership. Namely, too much employee control rights permeate corporate socialism, negating the benefits of employee capitalism. The second is a selection story: Small

collective employee behavior by making them owner-employees. The reduction in slack will enhance firm performance.

When product market competition is strong (eHHI low), the positive valuation impact small ESOPs have is much smaller at 8% with 10% statistical significance. When firms operate in a highly competitive environment, survival requires high efficiency, leaving little room for improvement through employee and team incentives. Thus, the potential gain to shareholders is also small.[26]

## IV. Conclusion

In this paper we investigate whether adopting broad-based employee stock ownership enhances firm performance by improving employee incentives and team effects. That is, does employee capitalism work? If so, how are gains divided between shareholders and employees?

We find that small ESOPs increase productivity. However, unlike the evidence of Jones and Kato (1995) on Japanese ESOPs, our evidence of productivity gains is obtained by estimating the effects on two main beneficiaries of such gains; namely, employees and shareholders. Because both gain from adopting small ESOPs, we infer employee share ownership improves worker productivity.

A closer examination reveals that employees capture the lion's share of productivity gains in competitive industries, whereas shareholders capture most of the gains in concentrated industries. We interpret this as product market competition also affecting within industry job mobility. A competitive industry means more alternative employers, enabling workers to share a greater portion of their productivity gains. A

[26] We are awaiting disclosure of results comparing operating profit returns by industry concentration.

concentrated industry, on the other hand, means less within industry worker mobility, strengthening shareholders position during wage negotiations.

Large ESOPs, defined as those controlling more than 5% of shares outstanding, have a more or less neutral effect on both employee compensation and shareholder value, suggesting little productivity gains. This difference between small and large ESOPs can be explained by non-value creating motives specific to large ESOPs: Means to fend off hostile takeover bids and to conserve cash by cash constrained firms. When large ESOPs are used for these purposes, they do not improve team effects or collective employee behaviors that are necessary for worker productivity gains.

Finally, even when ESOPs are adopted to form worker-management alliances, a form of corporate socialism, we find no evidence that employees are able to extract *unearned* compensation increases. Although there might be some exceptions, the neutral effects large ESOPs have on shareholder value does not support the notion that broad based employee share ownership leads to value destroying corporate socialism.

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## ISSUE HIGHLIGHTS



RESOURCES CONTACT SHARE
CASE STUDY OWNERS' PAGE

EMPLOYEE OWNERSHIP REPORT

MARCH–APRIL 2020
VOLUME XL, NO. 2

SUPREME COURT RULING

# Second Circuit to Reconsider Disclosure of Insider Information

In its seminal ruling in *Dudenhoeffer v. Fifth Third Bancorp*, the Supreme Court ruled that for a suit to succeed against fiduciaries in an ESOP and 401(k) employer stock case on the basis of inside information, plaintiffs must "plausibly allege an alternative action that the ERISA fiduciary could have taken that would have been consistent with the securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it." One issue this raises is whether an insider acting in a fiduciary capacity could have or should have disclosed insider information that would adversely affect the stock price.

In *Jander v. Retirement Plans Committee of IBM* (2nd Cir. Dec. 10, 2018), the Second Circuit ruled that the *Dudenhoeffer* ruling laid out conflicting standards for determining whether a plaintiff has plausibly alleged that a proposed alternative action would not have done more harm than good. The court ruled the plaintiffs had convincingly argued that early disclosure and correction of financial issues raised about accounting and other irregularities at its microelectronics division (which was ultimately sold) could have done more good than harm. The fiduciaries, the plaintiffs argued, could have taken action to correct these issues earlier and disclosed them to the market. In a presumably efficient market, the court said, the price would ultimately reflect the problems anyway. In light of all this, the court said the plaintiffs had made a sufficient plea to require remanding. The defendants appealed to the Supreme Court.

In *Retirement Plans Committee of IBM v. Jander et al.*, No. 18-165 (Jan. 14, 2020), the Supreme Court sent the case back to the Second Circuit to consider issues not raised in its decision.

*—Continues on page 6*

AFTER ESTABLISHING AN ESOP

# How Do Employer 401(k) Contributions Change?

**We are often asked how companies with both an ESOP and a 401(k) plan set their 401(k) contribution policies compared to non-ESOP companies. One specific question is whether companies reduce their employer 401(k) contributions after establishing their ESOPs. We studied this question using Department of Labor Form 5500 data from 2010 through 2016, the most recent year with available data. Our analysis finds that companies tend to slightly reduce their 401(k) contributions after setting up an ESOP, but that their contributions to the new ESOP considerably outweigh this decrease.**

We examined companies that established an ESOP in 2013, which enabled us to look at three years of 401(k) contributions both before and after the ESOP was created. We excluded companies with a combination ESOP/401(k) (a KSOP), as our aim was to study companies that maintain a separate 401(k) plan alongside their ESOP. We also limited our focus to literal 401(k) plans, excluding other defined-contribution plans such as profit-sharing plans.

A total of 191 privately held companies established standalone ESOPs effective in 2013. Of these, 110 or 58% also reported contributing to a separate 401(k) plan in at least one plan year before or including the year the ESOP was established (2010-2013). These 110 companies made up our sample. Nearly all these companies kept their 401(k) plan after establishing the ESOP, but three companies did not file a Form 5500 for their 401(k) plan in 2014-2016; we conservatively treated these companies as contributing $0 in 401(k) contributions post-ESOP.

We compared the average cash contribution per active participant from the employer to the 401(k) plan in the years before and including the ESOP's creation (2010-2013) and after the ESOP's creation (2014-2016). When a 401(k) plan filing was missing for a given year, we excluded that year from the average.

The median company's per-participant 401(k) contributions were essentially unchanged before and after the ESOP. Half of the companies in the sample increased their 401(k) contributions on average after the ESOP, while the other half decreased their 401(k) contributions. The median company increased its 401(k) contributions by 1.5% in 2014-2016 over 2010-2013. In absolute dollar amounts, this translates to an average of $19 more per participant per year. The inflation rate averaged 1.68% over this period, washing out the slight nominal increase to a slight real decrease.

However, though decreases and increases in 401(k) contributions were equally common, the decreases were of larger magnitude. The median employer 401(k) contribution among the companies in the study was $366 lower per active participant per year after the ESOP than before, and a nontrivial number of companies (15%) stopped 401(k) contributions altogether after setting up the ESOP. See Table 1 for more detail.

**TABLE 1.** Average yearly dollar employer contributions per active participant in companies that established an ESOP in 2013

| PERCENTILE | 401(K) CONTRIBUTIONS PRE-ESOP (2010–2013) | 401(K) CONTRIBUTIONS POST-ESOP (2014–2016) | ESOP CONTRIBUTIONS (2014–2016) |
|---|---|---|---|
| 10th | $113 | $0 | $615 |
| 25th | $656 | $158 | $1,736 |
| 50th (median) | $1,308 | $942 | $4,789 |
| 75th | $2,481 | $1,940 | $9,177 |
| 90th | $4,020 | $3,979 | $15,288 |

We compared the two time periods and found that the decrease after the ESOP effective year was statistically significant according to a paired sample t-test (a test to determine if this is a random result).

Of course, the ESOP represents an additional retirement benefit, so looking only at the 401(k) side gives an incomplete picture. In the sampled companies, contributions to the ESOP vastly outweighed the slight decline in employer 401(k) contributions: on average, these companies contributed $6,870 per active participant per year to their new ESOPs in 2014-2016, and the median company contributed $4,879.

These findings carry a number of caveats. The time period is limited, which prevents observing the long-term behavior of companies. Companies that established ESOPs in 2013 are not necessarily typical ESOP companies. The three years before and after ESOP creation may not represent typical plan years, and it is possible that the ESOP companies in the sample will modify their 401(k) contributions over a longer period than three years. As well, economic trends over the 2010-2016 window (during which the economy was in recovery from the 2007-2009 Great Recession) may have been more significant drivers of company behavior than the ESOP. Per-participant dollar contributions is an imperfect proxy measure for how companies set their 401(k) contribution policies. Finally, we intentionally excluded the approximately 6% of ESOP companies with a separate defined-contribution retirement plan that is not a 401(k) plan. For all of these reasons, these findings should not be treated as definitive.

Still, our tentative findings track with what might be expected: setting up an ESOP tends to be followed by a modest but significant reduction in employer-side 401(k) contributions, a reduction far outweighed by substantial new employee retirement assets in the ESOP itself.

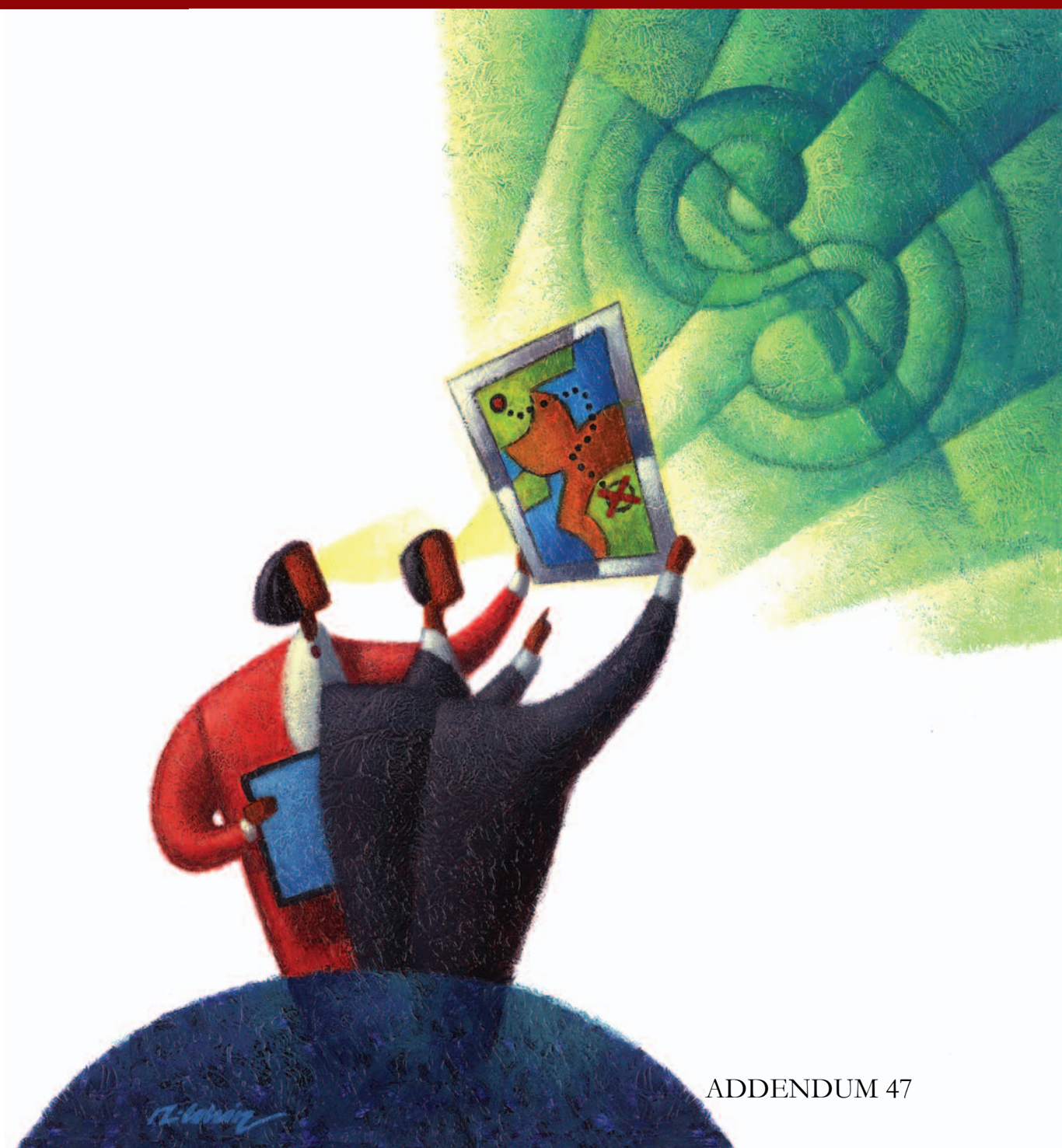
A natural follow-up question is how *employee* 401(k) contributions change once an ESOP is in place. We will explore this in a future article. ■

NCEO
The National Center for Employee Ownership

# UNDERSTANDING AND COMMUNICATING ESOP VALUATIONS

Paul Horn

An NCEO Issue Brief



ADDENDUM 47

# **UNDERSTANDING** AND COMMUNICATING **ESOP VALUATIONS**

PAUL HORN

*An NCEO Issue Brief*

April 2013
$15 NCEO members / $25 nonmembers



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# Contents

# Why Use an Appraiser?

Appraisers are used to place a dollar figure on various assets that do not have a readily ascertainable value like antiques, artwork, jewelry, real property, baseball cards, or a private business. Those who have bought or refinanced a house are familiar with home appraisers and, as discussed below, the ESOP valuation process has certain similarities to a home appraisal.

The valuation process is both an art and science. Various mathematical formulas and accepted standards are followed, but the very nature of the process gives discretion to the appraiser to exercise professional judgment within these guidelines.

A good definition of valuation is "the art of assessing the relationship between an asset's future investment returns and the risk of achieving those returns." In the case of a business, it is the art of assessing the present enterprise value of the company based on its expected future performance and ability to generate cash.

Except in certain circumstances, an owner of a privately held company need not determine the value of the company and the shares so held. When circumstances to value the shares do arise, such as transfer by gift, inclusion in the owner's estate, or (as discussed here) the sale to or holding of shares by a private company ESOP, then an appraiser will be engaged to determine the value of these private company shares.

The basic rules regarding the determination of asset value for tax purposes begin with Internal Revenue Service (IRS) Revenue Ruling 59-60, 1959-1 C.B. 237, which defines fair market value as: "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."[1]

When a retirement plan buys or sells assets, additional valuation rules apply. The "exclusive benefit" rule requires that the amount paid for any investment by the retirement trust must, among other requirements, not exceed the asset's fair market value at time of purchase.[2]

These IRS rulings essentially were incorporated in the Employee Retirement Income Security Act of 1974, as amended (ERISA). ERISA states that an ESOP can pay no more than "adequate consideration" for a selling shareholder's stock for the sale to be permissible under the "prohibited transaction" rules.[3]

Once shares are inside the ESOP, valuation by an independent appraiser is required by Section 401(a)(28)(C) of the Internal Revenue Code of 1986, as amended (the "Code") if these shares are not readily tradable on an established securities market (as defined at Treas. Reg. Section 54.4975–7(b)(1)(iv)).

In a defined contribution plan, Rev. Rul. 80–155, 1980–1 C.B. 84, provides that amounts allocated or distributed to participants must be ascertainable, and therefore the plan must value trust assets (including employer securities) "at least once a year, on a specified inventory date, in accordance with a method consistently followed and uniformly applied."[4]

1. Rev. Rul. 59-60 was modified by Rev. Rul. 65-193 (1965-2 C.B. 370) regarding the valuation of tangible and intangible corporate assets. Rev. Rul. 59-60, as so modified, was then extended to the valuation of corporate securities by Rev. Rul. 68-609 (1968-2 C.B. 327). Rev. Rul. 77-287 (1977-2 C.B. 319) amplified the factors in Rev. Rul. 59-60 as applied to the valuing of restricted securities.

2. Rev. Rul. 69–494, 1969–2 C.B. 88.

3. ERISA Section 408(e)(1); see also Internal Revenue Code Section 4975(c)(13), which refers back to ERISA Section 408(e).

4. Form 5500 requires a statement of plan assets at fair market value as of the beginning and end of the plan year. The income statement on Form 5500 notes unrealized appreciation or depreciation in plan assets. A question on Form 5500 also asks whether any non-cash contributions (real estate, collectibles, and closely held stock, etc.) were made to the plan, the value of which was set without an appraisal by an independent third party.

# An Introduction to ESOPs

19th Edition

**Scott S. Rodrick**

The National Center for Employee Ownership
Oakland, California

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.

This publication is a concise, general overview of how ESOPs work. As such, it frequently omits special exceptions or circumstances, as well as much detail. There are many resources, including National Center for Employee Ownership (NCEO) publications and the informational resources available to NCEO members, that can help you explore this area further. If you do decide to proceed with considering an ESOP, you must obtain the advice of competent professionals who are experienced in the field. The NCEO maintains a searchable database of employee ownership consultants (the Service Provider Directory) that is available online.

A detailed technical review of this edition was provided by attorney Kevin Long of Employee Benefits Law Group. Appraiser Kathryn F. Aschwald of Columbia Financial Advisors reviewed the chapter on valuation when it was originally written. The author thanks them for their generous assistance.

**An Introduction to ESOPs, 19th ed.**
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# Contents

and dependent on the seller?), and so on. Similarly, applying discounts for lack of control may be a complex process.

The share price will also usually reflect a small (5% to 10%) discount for the fact that the shares are not readily marketable.

***The post-transaction price drop.*** When a company borrows money to finance a leveraged ESOP transaction (as when the ESOP buys a large block of stock from shareholders), the debt it takes on goes on its balance sheet, thus reducing its value. Thus, immediately after the transaction, the company will be worth less than what the ESOP paid for it. This can be confusing for ESOP participants if the company does not explain that their benefit at the outset of the ESOP is not reduced by this drop because their first ESOP allocation is at the post-transaction value. Over time, as the debt is repaid, the value of the company's stock will rebound, all other things being equal. Moreover, the potential tax and employee productivity benefits from the ESOP can accelerate this rebound and make the company (and thus the ESOP participants' accounts) worth more than ever.

The company may adopt a floor price protection agreement (also called a "floor put") that compensates some or all departing participants for the price drop during a stated period of time, generally by paying them the difference between the price they receive for their shares and the price they would have received but for the leveraged transaction. This would generally be done where the ESOP is already in place and a new leveraged transaction causes a decline in value due to the additional debt, causing departing participants to receive a smaller payout due to the post-transaction price drop.[1]

***Hiring an appraiser; who the appraiser works for.*** As noted above, the ESOP trustee must hire an independent appraiser for the ESOP transaction and subsequent valuations, and we at the NCEO recommend a truly independent one with no financial relation to the company or other parties to the transaction (such as the attorney or other advisors involved with the

1. By the time participants vest, build up enough in their ESOP accounts so the stock price has a significant impact on them, leave the company, and receive distributions after the original transaction, the stock price is likely to have recovered from the initial post-transaction price drop. With a subsequent transaction, participants will have been around long enough so that they might leave and start receiving distributions while the post-transaction price drop from the subsequent transaction still drags down the value of their shares.

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# EMPLOYEE OWNERSHIP REPORT

JANUARY–FEBRUARY 2020
VOLUME XL, NO. 1

## ISSUE HIGHLIGHTS



RESOURCES CONTACT SHARE
CASE STUDY OWNERS' PAGE

ESOP SUSTAINABILITY

## Time to Refresh Your ESOP?

**Tom Peters, a management consultant who rose to considerable fame in the 1980s (and who was a fan of employee ownership), is famous for telling companies that "if it ain't broke, you just haven't looked hard enough. Fix it anyway."**

Maybe you have had your ESOP for a long time and things are going reasonably well. The plan rules, governance structure, and ownership culture programs are mostly what they have been for a long time too. So since it is not broken, should you be thinking about fixing it? The answer is a resounding maybe. At the very least, it is worth doing a diagnostic on some key issues and seeing if there are changes that would help.

—Continues on page 5

FIDUCIARY DUTIES

## How ESOP Boards and Trustees Interact

ESOP company boards and ESOP trustees both have fiduciary obligations under ERISA to act in the best interests of employees as shareholders. It is very important that the board and trustee understand their own and each other's duties as well as how they need to work together on the following issues:

**Election of directors • Annual valuation updates • Repurchase liability**

**Acquiring another business • Responding to unsolicited offers • Selling the company**

—See page 5



**THE NCEO** is a self-sustaining nonprofit membership organization that provides practical resources and objective, reliable information on employee stock ownership plans (ESOPs), equity compensation plans, and ownership culture. Our publications, meetings, webinars, and research are designed with you in mind.

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RECENT RESEARCH

# DOL Data Shows Strong Rates of Return for ESOPs

**A common concern about ESOPs is their potentially higher level of risk for participants than a diversified 401(k) plan. As the argument runs, investments in a single company's stock carry more uncertainty than the same amount of investment in a diverse portfolio, and this risk is compounded when the company is also the investor's employer. Critics of ESOPs point to spectacular failures like Enron, where thousands of employees lost their retirement savings, ignoring that participants in 401(k) plans during steep market declines also often suffered dramatic losses.**

Still, the argument for diversification seems theoretically sound, but in practice rarely plays out for several reasons. For one, ESOPs tend to be an additional benefit rather than a substitute for a more traditional 401(k) retirement plan. Companies with ESOPs are more likely to have an additional retirement plan than non-ESOP companies are to have any retirement plan at all (32% of private-sector workers do not have access to a retirement plan, according to data from the National Compensation Survey). As well, ESOPs have built-in diversification. Participants are entitled by law to diversify up to 50% of their ESOP assets upon reaching age 55 and 10 years of participation in the plan, and many mature ESOPs diversify their plan assets over time as the plan evolves.

Data from the Department of Labor on the rates of return for pension plan assets offer another reassuring piece of evidence for ESOPs. This data show that ESOPs have robust and consistent rates of return, and in fact have slightly outperformed 401(k) plans in terms of asset growth.

The DOL's data, which examines plans with 100 or more participants, shows that the average annual rate of return for ESOPs from 2007 through 2016 was 5.8%. By comparison, the rate of return for 401(k) plans was 5.0% over the same period. The DOL calculates yearly rates of return for retirement plans by dividing the change in assets due to investments by the amount of investible assets. The averages are expressed as the geometric mean of yearly returns. These data are consistent with earlier DOL analyses between 1990 and 2010, which showed both higher returns on ESOP assets and lower volatility than in 401(k) plans.

Table 1 shows the year-by-year performance for ESOPs and 401(k)s since 2007. ESOPs had higher rates of return than 401(k) plans in eight of those 10 years.

The volatility of ESOPs, expressed as the standard deviation in yearly returns, was also lower over this period: 10.8% for ESOPs compared to 11.9% for 401(k)s.

ESOPs' lower volatility may be due in part to the required annual independent appraisal for closely held ESOP companies, which typically projects earnings out over several years and calculates a risk-adjusted present value. This has the effect of smoothing out year-to-year swings, as multiple years of projections are incorporated into each year's valuation.

**TABLE 1. Aggregate Rates of Return Earned by ESOPs and 401(k) plans, 2007–2016**

| YEAR | ESOPS | 401(K) PLANS |
|---|---|---|
| 2007 | 8.2% | 7.6% |
| 2008 | -21.9% | -24.9% |
| 2009 | 15.0% | 18.8% |
| 2010 | 13.2% | 12.0% |
| 2011 | 2.0% | 0.1% |
| 2012 | 11.2% | 11.2% |
| 2013 | 18.9% | 18.3% |
| 2014 | 7.8% | 6.7% |
| 2015 | 1.0% | 0.1% |
| 2016 | 8.5% | 7.6% |
| Standard Deviation | 10.8% | 11.9% |

*Source: Department of Labor, 2016 Private Pension Plan Bulletin*

The Department of Labor data also shows that ESOPs were stricken less severely than 401(k)s by the Great Recession: In 2008, the crash year, the decline in ESOP asset value was shallower than in 401(k)s by three percentage points. Going back to the previous recession, in 2001, tells a similar story: ESOP assets dipped by 4.8% that year compared to a 6.4% decline for 401(k) plans. This comports with other research on employee ownership companies' hardiness in downturns: A 2017 study found that companies with employee stock ownership had only half as many layoffs as other companies during those two recessions. ■

APPLICATIONS NOW ACCEPTED

# Apply for the 2020 Innovations in Employee Ownership Award

Does your company have innovative practices or unique elements of your ownership culture worth sharing with the employee-ownership community? Applications for the 2020 Innovations in Employee Ownership Award are currently being accepted. The deadline to apply is Feb. 21. Winners will be presented with the award and recognized at the NCEO's annual conference on April 21 in Minneapolis, Minnesota. An award committee determines the winning companies using a number of factors including the positive impact the innovation has on the company's culture, performance, employees, the industry, the employee-ownership community, as well as the public perception of employee ownership. Any company with a stock or stock-based program is eligible (from ESOPs to stock appreciation rights). Companies may apply directly or be nominated by third parties. In the case of a third-party nomination, the company nominated will be contacted and asked to fill out an application. There is no fee for companies to apply for the Innovations in Employee Ownership Award. ■

**For more information, contact Dallan Guzinski at DGuzinski@NCEO.org or 510-208-1301.**

NCEO
NATIONAL CENTER FOR EMPLOYEE OWNERSHIP

# EMPLOYEE OWNERSHIP REPORT

JANUARY–FEBRUARY 2016
VOLUME XXXVI, NO. 1

## ISSUE HIGHLIGHTS



RESOURCES CONTACT SHARE
CASE STUDY OWNERS' PAGE

ESOP COUNT

## Mixed Trend Continues

According to the latest data available from the Department of Labor, there were 6,795 ESOPs covering close to 14 million participants and holding more than $1.2 trillion* in plan assets as of the end of 2013. Among those plans, 81% were stand-alone ESOPs, and 19% were KSOPs (an ESOP that also has a 401(k) feature).

Analysis by the NCEO integrates information from the Compustat database with data from the Form 5500 to present the state of ESOPs in intricate detail. The tables *on page 3* break out the ESOP universe by public companies (EINs are associated with a stock ticker), and the remainder are presumed to be privately held. Table 1 shows that public companies represent 8% of ESOPs, 78% of ESOP participants, and 58% of employer securities. Table 2 shows that most public company ESOPs are KSOPs. Small, privately held ESOPs tend to be non-leveraged (Table 3). Table 4 breaks out the age of ESOPs by their plan's effective date as reported in the Form 5500. Older ESOPs as a category hold more than $1.1 trillion* in plan assets.

—*Continued on page 3*

* Editor's note: Amounts corrected since first publication

2016 INNOVATIONS IN EMPLOYEE OWNERSHIP AWARD

## Call for Applications

Applications for the 2016 Innovations in Employee Ownership Award are currently being accepted at www.nceo.org/r/EOAwards. Winners of the award are recognized each year at the NCEO's annual Employee Ownership Conference. In collaboration with the Beyster Institute at the Rady School of Business of UC San Diego, the NCEO recognizes employee-owned companies for a number of innovative practices that stem from the development of effective ownership cultures and highly engaged workforces of employee-owners. By sharing these ideas with the employee ownership community, this award strives to encourage employee-owned companies to continue to innovate. *On page 8,* we discuss past winners of the award and the innovative practices that have helped these companies succeed and earn recognition.

—*Continued on page 6*



**THE NCEO** is a self-sustaining nonprofit membership organization that provides practical resources and objective, reliable information on employee stock ownership plans (ESOPs), equity compensation plans, and ownership culture. Our publications, meetings, webinars, and research are designed with you in mind.

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# Trends in Transaction Design and Management

**The NCEO's first-ever ESOP transaction survey shows a number of trends in how companies structure, manage, and evaluate ESOP transactions. The November-December 2015 issue of this newsletter included some initial highlights of the survey, looking at the characteristics of the 240 companies that responded to the survey between February and September of 2015.**

## Using the Data

This research is the first attempt in the ESOP field to gather and present the experiences of a large, diverse group of companies about their ESOP transactions, including scope, management, and satisfaction with the outcome. This study attempts to fill a major gap in knowledge about the ESOP world, although it is subject to limitations.

One limitation is that the transactions reported on here spanned substantial developments in the ESOP field, especially the fiduciary process agreement between GreatBanc and the Department of Labor. Appraisal standards, fiduciary scrutiny, and transaction structures are all different for the later transactions covered by this survey than for the earlier transactions.

A second limitation is that the 240 respondent companies represent a minority of all ESOP transactions, and there may be some bias in their behavior since many are likely members of the NCEO. Readers should exercise caution in drawing conclusions about ESOPs in general.

Nothing in these results should be construed as a recommendation or a description of a best practice. Anyone considering an ESOP transaction should consult with qualified professionals who have expertise with ESOPs. The NCEO's goal in producing this report is that this data may be the foundation for productive discussions about how best to structure and manage ESOP transactions, but readers should remember that it does not provide any answers on its own.

## Dimensions of the Transactions

The most typical responding company had annual revenues from $10 to $50 million. The most common post-transaction percentage of shares owned by the ESOP was 100%.

The survey asked respondents about their most recent transaction, whether it was an initial or second-stage transaction. Most respondents (58%) answered about an initial transaction. Just over half (54%) reported that the value of the transaction was $5 million or less, and most of the rest (36%) had transactions worth $5 to $25 million. Just under half of the transactions were very recent (2012 or later), though 11% were from 2000 or earlier.

The size of the transaction in terms of the percentage of company equity involved varied dramatically, as Table 1 indicates.

**TABLE 1: SIZE OF TRANSACTION**

| | # | % |
|---|---|---|
| Less than 10% | 28 | 12% |
| 10 to 49% | 92 | 41% |
| 50 to 99% | 47 | 21% |
| 100% | 59 | 26% |

N = 226

Looking only at responses about initial transactions, the ratio of transactions for a minority versus a majority of shares remained fairly constant over time. The number of minority transactions declined only slightly (from 44% of all transactions in 2010 and earlier to 40% after 2010). The number of initial transactions that involved 100% of the shares of the company increased dramatically, from 38% for 2010 and earlier to 56% for after 2010.

The median amount of time it took responding companies to complete their transactions was six months. Ten percent of respondents took 3 months or less, and another 10% took 12 months or more.

## Funding the Transaction

The majority of transactions included in this data (72%) were leveraged, and for the majority of those (60%), loans funded the entire amount of the transaction. See Table 2.

**TABLE 2: PERCENT OF TRANSACTIONS FUNDED BY LOANS**

| | % OF RESPONDENTS |
|---|---|
| Under 80% | 18% |
| 80 to 99% | 22% |
| 100% | 60% |

The senior note in those transactions had a median term of eight years.

Almost half of the transactions (46%) used at least some seller financing. Among those transactions that did use seller financing, the seller received stock appreciation rights or warrants in 27% of transactions.

Most transactions (63%) reported in this survey did not make use of the section 1042 rollover.

One in six transactions (17%) prefunded the plan with cash in the year prior to the transaction, and roughly 1 in 14 (7%) involved a transfer of assets from a separate and preexisting plan (usually a 401(k) plan).

## Services Used in Transactions

Respondents indicated which of a set of 10 typical services they used as part of their ESOP transactions. Not counting valuation services, which is mandatory and was at the top of the list, the services used by more than 50% of respondents were plan design services, separate legal representation for the company, trustee/fiduciary services, and separate legal representation for the trust. Just over a third had a separate feasibility analysis, and just under a third had separate legal representation for the sellers. Two services (procuring funding sources and separate advice for the seller) were each used in roughly one in seven transactions.

Overall, 65% of respondents used four or more of the services on the list, and 16% used 7 or more.

Four in ten respondents hired a "quarterback" to serve as a project manager for the transaction.

## Costs of the Transaction

The costs of an ESOP transaction are highly individual to each company

and reflect numerous variables, such as the complexity of the plan, the sources of financing, the amount of analysis performed, the number of parties involved, the amount of separate legal representation, and much more. Some conclusions are clear from the results of the survey.

Transactions are getting more expensive. The number of transactions costing $200,000 or more increased from 23% (for transactions occurring before 2013) to 32% (for those in or after 2013). Chart 1 has more detail.

The number of services used as part of the transaction has a major impact on the cost of the transaction. Among companies that used four or more services (see text above), 79% had transaction costs over $75,000, versus 35% for those that used 3 or fewer services, as Chart 2 shows.

Transaction costs tend to be higher for larger transactions: the great majority (75%) of transactions for 10% or less of the company's stock cost $75,000 or less, and those for 100% of company stock were most likely to cost $200,000 or more.

## Managing the Transaction

The results of this survey reflect the impact of regulatory and industry focus on governance practices during ESOP transactions.

As Table 3 shows, respondents to this survey who described ESOP transactions in 2012 or earlier have dramatically different results than those describing transactions in 2013 or later with regard to the rates of having outsiders serve as trustees in ESOP transactions. These changes would likely be even more pronounced if there were sufficient responses to show results for before and after June 2, 2014, the date that the DOL and GreatBanc signed and released the fiduciary process agreement.

**TABLE 3: TYPE OF TRUSTEE**

| | BEFORE 2013 | | 2013 AND LATER | |
|---|---|---|---|---|
| | # | % | # | % |
| Outside institution or individual | 71 | 51% | 48 | 65% |
| Other company insider | 43 | 31% | 19 | 26% |
| Seller | 25 | 18% | 7 | 9% |
| **TOTAL** | **139** | | **74** | |

## Comments

One question asked respondents about their satisfaction with the transaction. Overall it was high, with 83% saying they were satisfied (48% described the transaction as "very positive" and 35% as "somewhat positive"). In a separate question, respondents had a chance to share what one thing they most wish they had known going into their transactions. The comments below attempt to convey the diversity of their responses.

- *All the ways a plan could be designed. We were unaware of all the choices we could have made.*
- *Better understanding of repurchase, recycle, redeeming shares, and what the long-term effects are of each.*
- *How much of my time the transaction would take.*
- *I wish I'd had a better understanding of ESOPs in general.*
- *We should have done the 100% conversion sooner.*
- *How important it would be to communicate with employees during the process.*
- *How good it was going to be.*
- *In the plan design it is very important to consider where you will be and what things you will need 10 and 20 years out. Repurchase obligation and segregation strategies are not on the typical person's radar at the time of the transaction.*
- *Floor price protection.*
- *It was crazy to try to get it done in 3 months!*
- *An outside trustee should have been named to oversee the transaction.*
- *The initial and ongoing costs and complexities incurred in setting up and running the ESOP.*
- *We had no surprises, but we spoke with 3-4 companies beforehand and learned that the cost and complexity of the transaction was higher than originally planned. This was true in our case, but the overall benefit outweighs the cost in our mind.*

Several of the respondents either wished that they had taken the time to learn more before their transactions or said that researching ESOPs prior to their transactions had been useful in helping them achieve their goals. The NCEO's goal in this survey is to help companies do that research and to encourage them to have informed conversations with their professional advisors and with their peers in the employee ownership community. ■

**Tell us what you think! Send your comments or questions about this research or your ideas for this research to the NCEO's research director Nancy Wiefek at NWiefek@nceo.org.**

**CHART 1: YEAR OF TRANSACTION BY TRANSACTION COST**

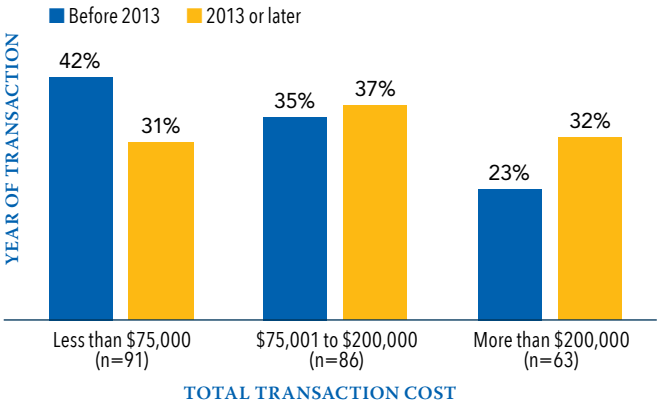
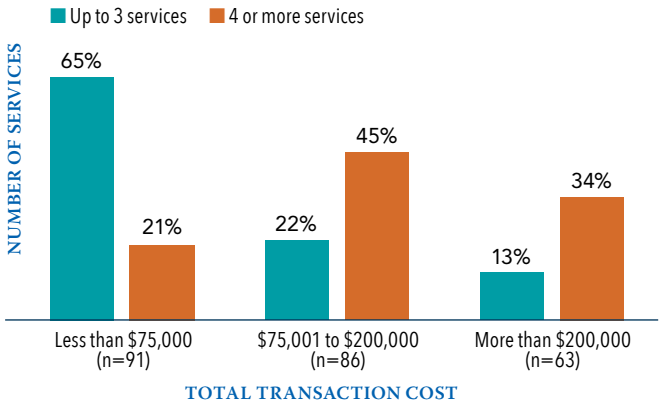



**CHART 2: NUMBER OF SERVICES BY TRANSACTION COST**



Benefits and Executive Comp Jun 1, 2020

# Are ESOPs Good for Employees?

Nov 9, 2010

Employee stock ownership plans, or ESOPs, are tax-favored retirement plans that are required by statute to invest primarily in the stock of the company that sponsors the plan. Over 10,000 companies now sponsor ESOPs, resulting in nearly 13 million ESOP participants and over $900 billion in ESOP-held assets. 1 See *A Statistical Profile of Employee Ownership*, at http://www.nceo.org/main/article.php/id/2/. The original research in this article shows that ESOP participants are better prepared for retirement than employees in similar non-ESOP companies: most ESOP participants participate in multiple plans, the value of the assets they hold is greater, and a greater share of those assets were contributed by the company.

The most frequent argument against ESOPs is that they leave employees excessively dependent on the performance of a single company. This argument is intuitive and compelling. A rational independent investor who owned the same assets as those held in the account of an average ESOP participant would almost certainly diversify that investment.

Critics add that ESOP participants have an even more compelling reason to seek diversification because it is not only the value of their retirement assets that depend on the success of the employer, but their paychecks and other benefits as well. ESOPs are detrimental, they argue, because ESOP participants are even more dependent on a single company than our hypothetical concerned investor.

A simple mental experiment, however, shows that diversification cannot be the only factor in making a rational choice between two portfolios. Let's assume that portfolio A is 50% diversified and portfolio B is 100% diversified. If their current worth is the same then portfolio B is the obvious choice. But what if portfolio A is worth twice as much? Since the diversified portion of portfolio A is worth the same as the entire value of portfolio B, the only rational choice for the investor is portfolio A.

Even more important, however, the analogy of the rational investor is fundamentally misleading in deciding about the merits of ESOPs from the perspective of plan participants. Unlike the investor, an employee's choice is not how to allocate a fixed dollar value of assets. The employee needs to decide where to work, so a more accurate question from the employee's perspective is whether working for an ESOP company is better or worse than working for a comparable company, presumably without an ESOP.

Answering this question is far more complex and fact-based than the simple answer suggested by the guideline to seek maximum diversification. It requires us to look at the entire package of benefits offered by different companies. Specifically, we will rely on the data presented here to determine answers to the following questions that define whether an ESOP company is a better or worse choice for a prospective employee:

- How many retirement plans does the company have?
- What is the value of the assets held by employees?
- Where do those assets come from?
- How concentrated in employer stock are those assets?
- What happens when plans terminate?
- How do plans affect different groups of employees?

This paper summarizes research by the National Center for Employee Ownership (NCEO) that attempts to answer these questions. Although the data has some inherent limitations, the results suggest that employees

companies are excluded.

## How Many Plans Do ESOP Participants Have?

ESOP participants have, by definition, at least one DC plan: the ESOP. More than half of them (56%) have a second DC plan, likely a 401(k) plan. In comparison, the Bureau of Labor statistics reports that 47% of companies overall have a DC plan. 2 See http://www.bls.gov/ncs/ebs/benefits/2009/ownership/private/table01a.htm In other words, an ESOP company is more likely to have two DC plans than the average company is to have any. Table 1 shows plan prevalence.

ESOP companies generally had established vehicles for retirement benefits and later added their ESOPs. The arguments against ESOPs are most compelling in companies where the ESOP is the only retirement plan, so we examined plan ages and plan establishment dates.

ESOPs tend to be more recently established than DC plans in the average non-ESOP company. The median age of an ESOP is 11 years, versus 13 years for non-ESOP DC plans. Table 2 shows the distribution of ESOP and non-ESOP DC plans by age.

Similarly, within a company with multiple DC plans, the ESOP is more likely to be the newer plan. As table 3 shows, for 65% of ESOP companies with two DC plans, the ESOP plan was adopted later than the other DC plan.

## What is the Value of Accumulated Assets?

Bearing in mind that our conservative method underestimates the combined value of multiple DC plans inside a single company, we estimate that the average ESOP participant in the average ESOP company has $55,836 in combined DC plans, compared with $50,525 for participants in non-ESOP companies with at least one DC plan. In other words, the average ESOP participant has somewhat more DC plan assets than the average DC plan participant, wrapping together both company and employee contributions and combining, whenever possible, multiple DC plans at each company. This relatively small difference grows when we control for company size, industry and age of plan, suggesting that net plan assets per participant are approximately 20% higher in ESOP companies than in similar companies with non-ESOP DC plans.

While the structure of this data only allows comparisons between ESOPs and companies with non-ESOP DC plans, the relevant comparison is between ESOP companies and all non-ESOP companies, including those without any DC plan at all. This data cannot make that comparison, but it is consistent with findings from other studies. Peter Kardas, Jim Keough and Adria Scharf, for example, found that ESOP participants had approximately 2.5 times the assets of employees in non-ESOP companies (excluding personal assets such as houses, cars, and IRAs). 5 Kardas, Peter A., Adria L. Scharf, and Jim Keogh, *Wealth and Income Consequences of Employee Ownership,* Oakland: NCEO, 1998. Given that approximately half of companies do not have any retirement plans, the 20% advantage of ESOP companies over companies with non-ESOP DC plans could easily translate into a 2.5 times advantage relative to the work force as a whole.

## Where Do Plan Assets Come From?

The average ESOP company contributed $4,443 per active participant to its ESOP in the most recently available year. In comparison, the average non-ESOP company with a DC plan contributed $2,533 per active participant to their primary plan that year. In other words, on average ESOP companies contributed 75% more

per participant to their ESOPs than other companies contributed to their primary DC plan.

Controlling for plan age, number of employees, and type of business increases the ESOP advantage to 90% to 110% above the non-ESOP companies in our sample. Not surprisingly, ESOP companies have much lower average contributions by employees than non-ESOP companies ($384 versus $2,848), and only 13% of ESOP companies report any employee contributions at all. See table 4.

While not included in this report, data for prior years are similar.

The value of the assets contributed by the company to all DC plans in ESOP companies is substantially higher than the value in non-ESOP companies. We estimate that the average ESOP participant has company-sourced DC-plan assets that are more than twice as much as participants in companies with non-ESOP DC plans. Even with the conservative assumptions in this study, we find that the average ESOP participant in the average ESOP company has company-sourced DC assets worth 2.22 to 2.29 times as much as the assets held by the average participant in the average company with a non-ESOP DC plan.

This ESOP difference is necessarily an estimate that depends on two assumptions. First, as noted, the data do not allow us to calculate the actual value of the assets per participant in combined DC plans. Second is our estimate for the portion of accumulated plan assets originally contributed by the company. The data do show how much of each year's contributions are from the company and how much are from employees and this number is stable. We believe it provides a reasonable basis to extrapolate how much of the accumulated assets in the average employee's account was originally a company contribution.

These data do not show participant assets held outside the company. Because ESOP participants contribute far fewer dollars to their ESOP than 401(k) plan participants, they have more take-home pay available, and some portion of that additional pay is used for asset-building activities (such as mortgages) or to avoid debts (such as college loans).

## How Concentrated in Company Stock Are ESOP Participants?

ESOPs are required by law to be primarily invested in company stock. In practice this means 50% of more of its assets should be stock, although the amount can be less for a limited time. Still, ESOPs do hold assets other than company stock. They often hold cash for various purposes, and federal law requires that participants meeting certain eligibility requirements be allowed to diversify a portion of their accounts into other assets.

Table 5 indicates that the percentage of company stock relative to total ESOP assets is stable at 84%. Not surprisingly, very little of the assets in the first DC plan in the non-ESOP companies is in the form of company stock. Typically the only non-ESOP DC plan that hold company stock in a publicly traded company, and few of them are included in this sample.

## What Happens When Plans Terminate?

What happens when companies terminate their ESOPs? This would seem to be the area where the critics of ESOPs are on their strongest ground, with ESOP participants facing risk to their retirement assets and their jobs simultaneously. Clearly in some circumstances the critics are correct: employees at United Airlines, for example, negotiated for shares and ended up making approximately $90 of wage and benefit concessions per share they received. When the ESOP trustee eventually sold those shares, they were worth less than $1.00, followed soon after by a loss of compensation during United Airlines' bankruptcy restructuring. United's defined