What factors influence a firm's decision to create, maintain or terminate an ESOP?

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According to the Employee Stock Ownership Association (ESOP Association), there are an estimated 10,000 Employee Stock Ownership Plans (ESOPs) covering roughly 10.3 million or 10% percent of American private sector employees. The ESOP Association also reported that the number of ESOPs have "remained steady" following a rapid increase in the late 1980s. Further, the ESOP Association 2010 Company Survey revealed that the average age of an ESOP was between 15 and 16 years <http://www.esopassociation.org/explore/employee-ownership-news/resources-for-reporters#statistics>. While these ESOP statistics are by no means trivial, from the standpoint of expansion, the fact the ESOPs are merely holding steady is cause for concern. Understanding what factors account for the decline in the rate of new ESOP formation is critical for the continued expansion of the ESOPs.

The ESOP Association noted that the decline in the rate of new ESOPs formation followed the removal of some federal government tax benefits in 1989. Thus, it appears that at least one exogenous factor, tax regulations, may have played some role in the decline of new ESOP creation. However, the fact that new ESOPs are still being established, albeit at a much slower rate, suggests that the removal of some tax incentives only partly explains the decline in new ESOP formation. Other factors within and external to a firm likely provide a more complete picture as to why fewer firms are creating ESOPs, and why some firms have terminated their ESOPs. This assertion is even more apparent considering that ESOPs still enjoy favorable tax benefits, despite losing some advantages in 1989. In addition to tax benefits, a growing body of research suggests that ESOPs are advantageous to both the firms and their employees. For example, ESOPs are associated with fewer layoffs, lower voluntary turnover, enhanced firm performance and increased employee satisfaction (see Kruse, Freeman, Blasi 2010 for an overview). Given this strong evidence in favor of ESOP formation, why do we not see continued rapid increase in ESOP formation? Further, why are some ESOPs being terminated? Are ESOPs simply a niche sector that has already reached the point of saturation? Unfortunately, scholarship on ESOP formation is currently lacking. Hence, the research proposed here aims to shed light on the problem of declining ESOP formation. In other words, why do some firms start, maintain, or discontinue an ESOP. To address these questions, I conceptualize the ESOP model as an innovative organization practice. I then draw on competing theories of innovation diffusion to collect and analyze interviews with executives of current, former and prospective ESOPs.

CONCEPTUAL FRAME

Theory and empirical research on the diffusion of new practices suggest that both exogenous and endogenous factors affect the spread and adoption of new practices. One approach suggests that diffusion is a social process, that is, people learn about and adopt new ideas from others in their social networks (Burt 1992, Coleman 1988, Granovetter 1973, Rodgers 1995). Another approach suggests that the ease of implementation is also important for the adoption of new practices (Blasi and Kruse 2006). Others identify firm performance, competitive pressures, (Huselid 1995), management and employee sentiment (Kurtulus, Kruse and Blasi 2011) and regulatory constraints as reasons why firms may adopt or fail to adopt new practices. I provide a brief overview of these competing hypotheses and their implications for ESOP formation below.

Social Networks

The social process approach suggests that firms are likely to adopt the ESOP model if others in their social networks adopt that model. For instance, Coleman (1988) posited that cohesive social networks allows for rapid and accurate dispersion of ideas, trust and norm enforcement. In other words, firms may be reluctant to establish ESOPs if few or no other firms in their surroundings have ESOPs. This may be particularly important for explaining the slower growth of new ESOPs, despite academic research showing the potential benefits of ESOPs. At a mere 10% of the USA private sector, ESOPs are significantly less prevalent than types of organizational ownership, thus widespread knowledge of ESOPs may be quite lacking. Further, Terpstra and Rozell (1997) suggest that firms rely more non-academic sources (practitioners and consultants) of information, thus it is possible that the wealth of academic research has not made its way into the networks of companies that may consider forming an ESOP. Thus, knowledge of how decision-makers in firms learn about ESOPs and the receptiveness of their network members to ESOPs may be crucial to ESOP expansion.

Ease of implementation and management

The ease of implementation approach suggests that the adoption of new practices may be a function of how easy said practices are to integrate into the existing organizational structure (Blasi and Kruse 2006). Blasi and Kruse supported this approach with the study of self-managing teams and work-related meetings. Work-related meetings were more likely to be adopted than self-managed teams because work-related meetings required less workplace restructuring to implement. If we apply this principle to ESOPs, it is possible that firms may be reluctant to start an ESOP if they view ESOPs as being particularly difficult or costly to set up relative to other types of ownership structures. Not only implementation, but cost of managing and maintaining and ESOP may also deter some firms from establishing an ESOP or influence the decision to terminate an existing ESOP. Hence, the quality of the information that firms receive about ESOPs and the cost sensitivity of the firm, may also significantly influence their decision to start or discontinue an ESOP.

Firm performance/competition

The ESOP Association reported that less that 2% of ESOPs were created from employee buyout of a failing company. Instead the majority of ESOPs were established to incentivize employees or buyout a retiring owner. However, high performing firms may be able to sell at a higher price to an outside buyer than to the employees. Competition from other firms may also affect whether a firm seeks out new practices. Blasi and Kruse (2006) found a negative relation between import growth and innovation adoption, and a positive relationship between exports and innovation adoption. However, they could not disentangle the causal mechanism. It is also possible that firm performance may interact with competition such that underperforming firms seek out innovation to boost performance. For example, struggling Silicon Valley startups commonly gave stocks to employs whom they were unable to pay large salaries as a way to retain talent. Hence, it is not clear how market competition will affect ESOP adoption.

Sentiment

How management and employees feel about ESOPs and each other may also play a significant role in the creation and termination of an ESOP. A recent study found that employees were generally in support of some performance-based compensation. However, support varied by the level of trust between management and employees (Kurtulus, Kruse and Blasi 2011). Low levels of trust reduced employee support of performance-based compensation, while high levels of trust increased support. General negative or positive sentiment towards ESOPs may also color management and employees perception and subsequently influence the creation and continuation of an ESOP.

Regulatory incentives/constraints

Government regulation in favor of or opposed to organizational practices may incentivize or curtail adoption of those practices, respectively. For instance, Dobbin and Dowd (2000) demonstrated that the 1897 Anti-Trust laws played in significant role in the reorganization of the United States railroad industries. Similarly, Miner et al. (1990) found that political affiliation was related to organizational change among Finnish newspapers. In the case of ESOP formation, the rapid expansion in the 1980s followed by the cooling period in the latter part of the 1990s suggests that the tax code changes preceding the decline impacted the creation of new ESOPs. Thus, tax changes and other regulations that favor or constrain ESOP activity will like influence whether companies create ESOPs or not. However, for reasons highlighted before, it is unlikely that tax incentives are the only factors that influence ESOP creation.

In sum, both exogenous and endogenous factors are likely to affect the expansion of ESOPs in the American private sector. Firms seeking an alternative forms of ownership may look to others in their social environment. However, the ease of cost of adoption and implementation will likely affect each firm differently depending on firm size, cost sensitivity, employee receptiveness and regulations in favor of or against adopting a particular ownership model. I use qualitative data from firms with established and previously established ESOPs in addition to data from firms considering ESOP formation to enhance understanding of ESOP diffusion and expansion.

METHOD

The above approaches identify various factors that likely affect new ESOP formation. To assess the adequacy of these factors, I am conducting interviews with Presidents, CEOs and CFOs of companies with established ESOPs, companies that terminated ESOPs and companies that are considering creating ESOPs. I combined random sampling and snowball sampling techniques to identify companies with existing ESOPs, terminated ESOPs and companies that considered ESOPs but decided against creating one. I used the 2011 Form 5500 list which all ESOPs companies are required to file with the federal government. The list contained 6543 companies, of which 383 companies were listed as terminated ESOPs. I drew random samples from the list using STATA data analysis software to obtain a representative sample of companies for interview. I also solicited referrals from the companies interviewed and ESOP service providers for companies that were considering or had considered, but decided against forming an ESOP. To date, I have collected data from 16 of an expected 30 companies representing a variety of industries and locations. Of these 16 companies, 10 are existing ESOPs, 4 are former ESOPs and 2 had considered forming an ESOP.

Interview questions included, "how they initially learned about ESOPs," "communication with other ESOPs," "employee and clients receptiveness towards ESOPs," "challenges of setting up the ESOP," "persons or forms consulted to set up the ESOP," "main reason for discontinuing an ESOP." Interviews will continue throughout the summer of 2015.

RESULTS

Although data collection is still ongoing, the preliminary results reveal rather interesting patterns. First, the representatives of existing ESOPs are quite passionate about their ESOPs. Of the 10 ESOP companies interviewed to date, 9 are one hundred percent ESOP and the other is forty percent ESOP. All 10 ESOPs were established as succession plans for a retiring owner. These owners and their representatives all stressed the importance of seeing the company lasting into the future, and saw the ESOP as a way of ensuring longevity. Several founding owners also saw the ESOP as a way of "staying involved" in the company in some capacity. The founding owner of a West Coast manufacturing company even remarked that, had he sold the company to an outside buyer, he would have little if any input in the company after the sale. By selling to the ESOP, he was able to stay on in the company as Chairman of the Board of Directors. All of the ESOP representatives interviewed also expressed a desire to "give back" to the employees who helped to build the company.

The ESOP representatives acknowledged the favorable tax benefits that ESOPs enjoyed, but saw the tax benefit more as a bonus than the primary motivation for establishing the ESOP. Indeed, in the one case where the ESOP was established only for the tax benefit, the ESOP was terminated not much later after being established. This was revealed in an interview with the VP and CFO of a medium-size manufacturing and technology company in Ohio, who has been with the company for more than 25 years from its founding to the present. The CFO revealed the founding owner simply wanted the tax benefit and was not invested in "forming and ESOP culture." The owner later bought back the portion of the stock sold to the ESOP, thus terminating the ESOP as he felt that it was not working as he had hoped it would. Three other ESOPs were sold after being made very lucrative buyout offers. Hence, the first of the terminated ESOPs appears to be one that should have never been due to the founding owner's primary motivation for creating the ESOP in the first place, and the others were made buyout offers that they felt they could not refuse.

Of the two companies that considered creating an ESOP, one decided against it and the other started the formal process to establish the ESOP. The former was a small company with fewer than 50 employees. The company founder cited start-up cost as the main reason for not proceeding with the ESOP. The latter company that did decide to pursue the ESOP cited wanting to share the success of the company with the employees who helped to build the company.

Interestingly, the founding owner of this medium-sized software and consulting company was far from considering retirement. He did not see the ESOP primarily as a succession plan, but rather as a way to further grow what was already a rapidly growing company.

These results provide a brief preview of the motivations for establishing and terminating an ESOP. A more comprehensive analysis will be provided upon completion of the interviews. Still, the results suggest that ESOP founding go beyond mere tax incentives. Indeed, the ability to stay involved in the company, to give back to the employees, and the desire to see the company survive long into the future were the dominant reasons given thus far for establishing an ESOP.

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