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Employee Stock Ownership Plans (ESOPs)

Objectives, Design Options and International Experience

Jeffrey R. Gates
Jamal Saghir

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Employee share schemes are becoming more prevalent worldwide. Originally designed as an ownership-broadening technique of finance, the term "ESOP" is now used to describe a wide variety of employee participation strategies covering a diverse array of applications. ESOPs are best known for their adaptability and flexibility across a broad range of economic, political, and cultural circumstances.

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EXECUTIVE SUMMARY

An Employee Stock Ownership Plan (ESOP) is a mechanism to facilitate employee ownership in a company. While broadening employee ownership, ESOPs can be a useful policy instrument for promoting privatization, improving enterprise performance, and raising money for the enterprise. These benefits account for the increasing use of ESOPs in both the developed and the developing world. The popularity of ESOPs, however, does not imply unanimity on issues relating to their design, implementation, or even the advantages associated with them. Indeed, the inherent flexibility of ESOPs explains their widespread adoption in a diverse set of economies. This paper reviews the international experience with ESOPs and provides a broad overview of the issues to be examined when considering the use of an ESOP.

Typically, an ESOP is structured as a separate legal entity to which a corporation sells shares. Employees are each allocated a number of shares which are held for them according to the terms of the ESOP. The terms are established by those who set up the ESOP. Funds required for purchasing these shares for the ESOP come from three basic sources: (1) employee funds; (2) employer contributions; or (3) external loans. To the extent that an ESOP is financed with borrowed money to be repaid with employer contribution, it is called a self-financed, leveraged ESOP. In either case, what distinguishes an ESOP from other employee ownership programs is that shares are paid for partly or fully out of future corporate earnings. It is because of this reliance upon future earnings that ESOPs are considered a valuable technique of corporate finance.

The widest experience with ESOPs is in the developed world where they can be found in enterprises spanning the economic spectrum from grocery store chains, hospitals, car rental agencies, and insurance companies to apparel manufacturers, airlines, and consulting firms. Interest in ESOPs in the developed world has been fueled by an interest in expanding capital ownership and a growing concern with productivity, with worker-management relations and with the need to raise capital for expansion or for transfers in ownership. Studies have shown that while employee ownership does not automatically improve the attitudes and performance of employees, both performance and attitudes can be positively influenced by ESOPs. A combination of employee ownership and participation in decision making bears a positive association with enterprise performance, but studies have not conclusively identified the optimum form or extent of such participation.

Although experience with ESOPs in developing countries remains limited, employee ownership now forms a component of privatization or economic development strategies in more than a hundred countries. ESOPs are used to advance privatization by creating political support for privatization and by alleviating labor concerns. For example, in low-income settings — where privatizations typically remain difficult to launch — employee ownership schemes provide a natural base from which to commence the privatization process. In other settings, employees have provided a ready market for shares, thus accelerating the pace of privatization. Employee ownership may also help soften the impact of privatization by giving employees an incentive to assist with the restructuring effort that often accompanies successful privatizations.

In a number of developing and transitional economies, government subsidies support the use of ESOPs as instruments of privatization. For example, in cases where self-financing ESOPs have proven insufficient or inappropriate to encourage ownership by cash-poor workers, ESOPs have been combined with government incentives such as share grants or discounts. These government incentives have indisputably advanced privatization in countries such as Jamaica, Chile, Poland, Hungary and Russia. However, given the shortage of public revenues in many countries and the implications of public sector deficits for macroeconomic stability, policy makers must balance the goal of employee ownership with the need for fiscal prudence while also discouraging short-sighted behavior on the part of the employees.

While a great deal of flexibility is possible in designing ESOPs, three core operational principles are considered crucial: the democratic principle (a broad cross-section of employees must be included in the plan); the anti-monopoly principle (the bulk of benefits must not be captured by a few participants); and the private property principle (participants must receive what is due them under the plan).

Within this broad framework, a number of specific design questions need to be decided. For example: Should all employees be eligible to participate, or just those employed by the operating unit that sponsors the plan? Should specific categories of employees (such as part-time or seasonal) be excluded? Should shares be allotted equally to employees or in proportion to their pay? Should there be a limit on the amount of pay that the plan may take into account, thereby limiting allocation disparities among employees to a specified range (such as 5:1 or 20:1)? When should employees have access to the shares? There are no standard answers to these questions and each ESOP must be custom designed to suit its environment.

This does not imply that the environment is always a given, unchangeable factor. In fact, governments can do much to promote institutional environments conducive to the growth of ESOPs. In developed countries, the success of ESOPs is largely attributable to such positive environmental factors as: government encouragement of their use as a flexible technique of corporate finance; well-established corporate and securities laws; and the availability of a range of sophisticated financial and other support services. In contrast, developing nations are often characterized by weak capital markets that possess few disclosure requirements, poor accounting and financial standards, scant publicly available information, and generally low levels of oversight or regulation. Implementing ESOPs in this environment — for either public or private enterprises — requires substantial care. However, this does not imply a need to await the ideal legal and regulatory environment, particularly where the objective is a limited one of implementing ESOPs on a pilot basis or promoting the privatization process.

Even after considering the financial and institutional issues, it is necessary to deal with a wide range of operational issues. For example, the presence of an ESOP does not imply that any particular class of shareholders has the right or the competence to manage a company. Therefore, one of the key issues in implementing ESOPs is how to ensure a proper balance between shareholder rights and responsibilities. This paper also reviews international experiences with regard to methodology for the valuation of employee shares where a market does not exist. In addition, it examines the role of labor unions and of employee education programs in promoting ESOPs.

International experience suggests that no single model of an ESOP will suffice for all situations and that there is no one uniformly correct method for their implementation. ESOP flexibility represents both a challenge and an opportunity for policy makers worldwide. ■

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FOREWORD

This paper examines international experiences with Employee Stock Ownership Plans (ESOPs). The primary objective of the study is to lay out the key factors involved in creating an ESOP in order to assist government, business, labor, and development leaders to come to an appreciation of the wide-ranging benefits they offer. Simultaneously, it provides a starting place for the origination of ideas on how best to go about setting up an ESOP.

After reviewing hundreds of ESOPs in a multitude of environments worldwide, the authors present in this paper suggestions culled from the most exemplary of these. Policy makers will find themselves interested in the macroeconomic, legal and regulatory issues related to ESOP use, especially in regard to their use in privatization. Business people may be prompted to see the usefulness of an ESOP for their organizations, while representatives of the working community may discover ways in which ESOPs can be used synergistically to increase both their own and their employer's financial security. While ESOPs are not a panacea, they can do quite a job of transforming problems into structures that benefit multiple parties.

As a central department of the World Bank, an important function of the Cofinancing and Financial Advisory Service (CFS) is to act as a clearinghouse for worldwide experiences that support sensible approaches to privatization and private sector development. We are pleased to present this review of international ESOP experiences. ■

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INTRODUCTION

In developed countries, Employee Stock Ownership Plans (ESOPs) have become a popular option for companies faced with the challenges of restructuring worker-management relations, improving productivity, facilitating ownership transfers, and raising capital within an increasingly competitive environment. In less developed countries, the push for privatization and democratization has made ESOP plans a very attractive tool. This paper explores ESOP international practices while providing an overview of the technical and design issues related to their use.

Designed as a mechanism to facilitate employee ownership in a corporation, the benefit of creating an ESOP, as compared to other employee ownership schemes, is that often an ESOP takes advantage of the company's future income to finance for employees the immediate purchase of a block of employee shares. The beauty of the ESOP is that its design can be adapted to achieve the goals of companies, employees, and governments with different environments, goals and values. Depending on the objectives of an ESOP's designers, ESOPs can look very dissimilar. For this reason, it is important to bear in mind that an ESOP is largely a set of "rules" governing the acquisition, allocation, and management of shares held for employees. Virtually all of these governing "rules" reflect the desires of the crafters of an ESOP.

At a practical level, most ESOPs come into existence by the decision of a company's management. An ESOP's goals, followed by its "rules," are then determined (perhaps within the constraints of a legal system governing their use). Next, shares are purchased for the ESOP either by the employees, the employer, or both. In any case, in order for the scheme to be an ESOP - as distinct from other employee share schemes - part of the purchase is financed with company-secured debt to be repaid out of future earnings of the company. This allows ESOP participants to benefit both from the future earnings of the company (as those earnings are applied to repay ESOP-related debt) and from an increase in wealth should the value of the company's shares increase beyond the price at which they were purchased.

For this reason, ESOPs can be a tool to help include employees in the economic growth of both their country and the companies for which they work. By providing a broader base of people an opportunity to share in the benefits of capital ownership, a more even distribution of the advantages provided to capital asset owners may result. Government policies that use subsidies (tax deductions, credits, deferred taxes, accelerated depreciation, interest rate discounts, etc. to stimulate investment (see Figure 1) will thus result in a broader base of people sharing in the benefits of such policies. By including an ESOP as a component of corporate finance, policy makers can enable workers, as well as traditional investors, to participate in the financial system. Involving employees in the financial markets may be especially important, given that the growth in business savings in developed countries has routinely outpaced the (undistributed profits and depreciation reserve) growth in personal savings (see Figure 2). ESOPs can lead, therefore, not only to income growth, increased employment and efficiency, but also to the long-term growth of capital markets and the participation of new entrants.

Designed as a mechanism to facilitate employee ownership in a corporation, an ESOP is often structured as a separate legal entity (such as a trust) that results in shares being held in individual accounts in trust for employees according to the terms of the trust. A corporation sells shares to the ESOP through one of three basic financing schemes: (1) deductions from employee compensation (payroll withholding, deferred bonuses); (2) employer contributions (of cash or shares); or (3) an external loan. Debt-financed purchases of ESOP-held company shares are typically secured by the company's assets and backed by the company's future earnings. Launching an ESOP, therefore, may not require an immediate injection of cash. Although the funding and utilization of ESOPs occurs in numerous ways, and to achieve a variety of economic, corporate, political, and social objectives,

ESOPs at their most fundamental level broaden employee ownership beyond the constraints imposed by the employees' personal ability to invest.

At its core, an ESOP is a technique of corporate finance. The ESOP concept acknowledges that income-producing assets can often be purchased on terms whereby they pay for themselves from the revenues they generate. Thus, ESOP financing utilizes this concept of self-liquidating debt to assist in enabling a company's employees to acquire an ownership stake in their place of employment. Without some element of such self-financing, an employee ownership scheme cannot rightly be labeled an ESOP (that is, because it is not structured as a technique of corporate finance). In addition, an ESOP reflects in its operations three key principles designed to ensure that (a) a broad base of employees are included as ESOP participants, (b) the benefits available under the ESOP are broadly spread among the ESOP's participants, and (c) those participants, over time, begin to receive an ownership income (dividends) to supplement their labor income, as well as an eventual pay out of their ESOP account balance.

Various types of employee share participation schemes have been common in the developed world since the turn of the century. The first major schemes, such as those implemented by Proctor and Gamble in the 1890s and Sears, Roebuck and Co. in the 1920s, were largely limited to profit-sharing funds invested in company shares. US legislation encouraging employee share schemes was enacted in 1921. However, the interest in ESOPs and other broad-based employee share participation schemes is a much more recent phenomenon.

The United States has experienced the greatest use of employee ownership plans since the first ESOP was created in 1956 (see Box 1). Currently, about 12 percent of the U.S. workforce participate in employee ownership schemes, including ESOPs established in approximately 10,000 companies nationwide. As businesses compete on a global scale, ESOPs are growing in popularity outside the United States. For instance, various forms of employee ownership plans have become an established component of economic growth and development in numerous developing countries, including Russia, Egypt, Jamaica, and Venezuela. ESOPs are also becoming a common component among multinational corporations seeking a means to harmonize corporate cultures across various national cultures.[1]

Broad-based employee ownership now forms a component of privatization and economic development strategies in more than 100 countries. Due, however, to the limited depth of experience in these countries, the discussion of ESOPs in this paper focuses on reviewing key practices and summarizing relevant experiences drawn primarily from developed country experiences. While of particular usefulness

[1]See Jeffrey R. Gates and David E. Reid, "Translating Your ESOP Abroad," *Financial Executive* (July/August 1994).

Figure 1 - Why Does Corporate Finance Create So Few New Shareholders?

Sources of Funds

Internal

Undistributed Profits — Reinvested for current owners

Depreciation Reserves — Reinvested for current owners

External

Debt — Repaid on behalf of current owners

Equity — Most affordable by current owners

Answer: Because conventional corporate finance is designed to finance capital for current owners, not to create new capital owners — with funds sourced via a "closed system of finance."

Source: U.S. General Accounting Office (1986).

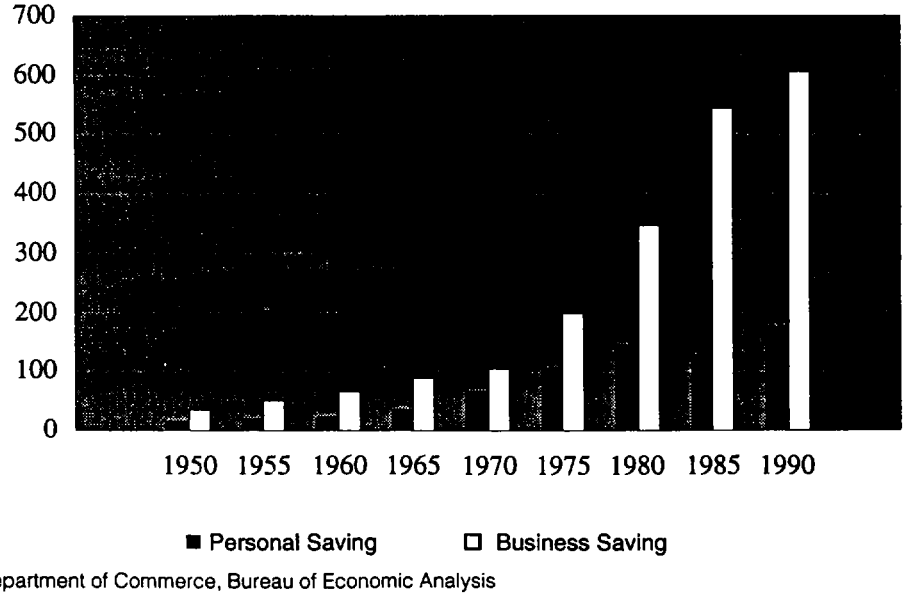
for less developed countries, the wide diversity of ESOPs studied enables the paper to incorporate a multitude of ideas for companies in any number of circumstances. The paper, therefore, is more like an ESOP cookbook, with the recipe chosen depending upon the ingredients at hand, rather than a mechanical application of a stereotypical ESOP plan.

Technical and policy issues involved in setting up an ESOP are discussed in the following chapters. Chapter I outlines the key components of ESOPs and discusses the policy objectives responsible for the blossoming interest in employee ownership. Chapter II summarizes the range of potential financing alternatives. Chapter III discusses design options. Chapter IV covers common operational issues. Chapter V discusses the financial, legal, and accounting environment necessary for employee stock ownership and reviews other institutional concerns. Chapter VI provides an overview of lessons learned, including those of special concern to developing countries. ■

Box 1. The First ESOP

The first ESOP — implemented by Peninsula Newspapers, Inc. in the U.S. in 1956 — arose when ESOP inventor Louis O. Kelso restructured the firm's profit-sharing plans to produce a financing mechanism to purchase 72 percent of the shares of a newspaper chain. The shares were acquired from three major shareholders and paid for from future company profits. The selling shareholders also acted as lenders by accepting interest-bearing notes from the company-sponsored profit-sharing plans; the company guaranteed the note. Each year during the term of the note, the company made a tax-deductible contribution to its profit-sharing plans. Those funds, in turn, were used to repay the notes. The key characteristics that distinguished the ESOP from a conventional profit-sharing plan were that: (1) it enabled employees to use *leveraged financing* to acquire a block of shares at the current price and have those shares paid for with the company's future pre-tax earnings; and (2) the ESOP's share acquisition debt was based on a corporate guarantee, so that individual employees bore no personal liability for that debt.

Figure 2 - Gross Saving: 1950 - 1990, Personal Saving vs Business Saving



Source: U.S. Department of Commerce, Bureau of Economic Analysis

CHAPTER I. THE MAIN OBJECTIVES OF ESOPs

ESOPs are often used to mitigate managerial, financial, and operational difficulties of enterprises large or small, unionized or not, public or private, growing or mature. Most commonly, ESOPs seek to accomplish one or more of four basic objectives, depending on the needs of the sponsors. These objectives are to: **(1) broaden ownership, (2) enhance enterprise performance, (3) facilitate privatization and other reforms**, and **(4) raise money for corporate purposes**.

In practice, because of the flexibility of the ESOP concept, multiple objectives often become intermingled in a single ESOP, and the same ESOP can be viewed quite differently by the various stakeholders. Many workers, for example, negotiate to include ESOP participation in their compensation packages, or view them as a device for securing their jobs and anchoring the company's physical capital; managers might view the same ESOP as a tool to ensure that employees share risks as well as rewards. Policy makers may turn to ESOPs to enhance economic performance and competitiveness and to create market-based solutions to socioeconomic challenges; development economists, meanwhile, might promote ESOPs as a way to overcome resistance to privatization, facilitate participation by cash-poor workers, or to diffuse capital ownership. Corporate finance specialists may rely upon the ownership-broadening power of ESOPs to finance corporate expansion, to create liquidity for shareholders in an unlisted company, or to avoid an outright sale when a company needs to raise cash. The prevalence of these wide-ranging perspectives on and uses for ESOPs suggests the potential complexity of a fundamentally simple mechanism.

BROADENING OWNERSHIP

The most basic characteristic of the ESOP is its ability to broaden ownership,[2] thereby creating the conditions upon which the other three objectives depend. Precisely because ESOPs provide a broad group of workers the means to acquire capital ownership and to increase their stake in the corporation, ESOPs provide tools for improving performance, overcoming workers' resistance to privatization, and raising money to finance corporate goals. The central objective of broadening ownership appears key to the recent interest in ESOPs in developing countries, especially for countries undertaking privatization. The ways that broadening ownership help to improve enterprise performance, facilitate privatization, and raise money for corporations are discussed below.

ENHANCING ENTERPRISE PERFORMANCE

Central to the debate about the value of ESOPs is the question of whether they improve enterprise performance. Recent evidence suggests that while ESOPs alone do not always enhance performance, such improvements result more often when an ESOP is combined with a system of workplace participation. Employee participation programs, such as quality work circles, continuous improvement programs, and total quality management can open communication channels between employees and management.[3]

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[2]"It is important to understand the fundamental distinction between employee ownership as a form of private ownership on the one hand, and collective ownership, such as in the state farms in the former Soviet Union, and the township and village industries in China, on the other. In the former, the link between the private ownership and return on capital is clear and the reward for labor is market-based. In the latter, the incentives for performance are based on non-market stimuli such as the plan, peer pressure, and effort minimization." See Zeljko, "The Role of Employee Ownership in Privatization of State Enterprises in Eastern and Central Europe," World Bank Internal Discussion Paper, 1991, footnote 6.

Especially in the US, where the bulk of ESOP-related research has been concentrated, a number of studies have shown that joint financial and workplace participation can positively influence productivity, efficiency, and profitability.[4] In addition, the Employee Ownership Index,[5] which regularly compares the share price performance of employee ownership companies with a broad range of other indices (Dow Jones Industrial Average, the Standard & Poor's Midcap 400, etc.), indicates that the market favors companies with at least 10 percent employee ownership.[6]

A 1994 review of the employee ownership literature compiled data from 51 studies, 25 on employee attitudes and behavior and 26 on productivity and profitability.[7] Of the 25 studies on attitudes and behavior, the overall conclusions were that:

1. Employee ownership does not automatically improve employee attitudes and behavior; and
2. Employee ownership often improves or does not affect employee attitudes and behavior, but rarely has a negative impact.

In addition, the studies suggest that:

3. Where different attitudes or behavior are linked to employee ownership, they are almost always linked to the status of being an employee-owner, and not to the size of the employee's ownership stake;
4. Perceived participation in the decision-making process, with or without employee ownership, often has a positive effect on employee attitudes;
5. Despite the possible benefits of increased employee participation in decisions, employee ownership does not automatically lead to increased participation; and
6. The need or desire for union representation does not decrease in firms with employee ownership.

The performance studies concluded, in a close parallel to the results of the attitudinal behavioral studies, that:

7. Employee ownership does not automatically improve productivity or profitability of a firm; and
8. Employee ownership often improves or does not affect performance productivity or profitability of a firm, but rarely has a negative impact.

Conclusions drawn from these studies also highlight that employee ownership does not divert profits into wages and benefits, decapitalize the enterprise, imperil efficient management, or hurt the firm's chance of attracting outside investors. Also, no evi-

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[3]Productivity gains significantly exceeding the norm were found in a survey of 1,100 US ESOP companies in which non-management employees participate in corporate decision making through work groups and committees. See General Accounting Office, *Employee Stock Ownership Plans - Interim Report on a Survey and Related Economic Trends*, February 1987, p. 4. Because this line of analysis was associational rather than causal, researchers could not determine whether such participation leads to productivity improvement among ESOP firms, or whether otherwise better performing firms tend to give more opportunities for participation to non-managerial employees. See also *The Employee Ownership Casebook,* National Center for Employee Ownership, Oakland, CA, 1986, which notes that employee ownership firms that practice participative management grew 8-11 percent per year faster (1981-85 data) than they would have been expected to grow without employee ownership and participation alone. For a survey of the research to date regarding the performance effects of US ESOPs, see Stephen C. Smith, "Implementing Employee Ownership in Developing Countries: The Law and Economics Framework for Privatization," George Washington University, Economic Working Paper 9208, Washington DC, 1994.

[4]In US.-based studies that found a correlation between employee share participation and job satisfaction, reported job effort, and workers' stated commitment to their firms, the correlation was strengthened by employee participation in decision making. However, researchers have found it difficult to isolate the impact of participation on enterprise performance, because highly participatory firms also often have in place other programs such as a commitment to avoid layoffs. See Smith, ibid. See also Michael C. Jenson, "Eclipse of the Public Corporation," *Harvard Business Review*, Sept.-Oct. 1989, who notes that having "insiders" without ownership is a wasted opportunity to improve enterprise efficiency. See also *The Economist,* May 5, 1990, describing the distinction between "spectator capitalism" and "proprietor capitalism."

[5]Since 1991, the Employee Ownership Index has been published quarterly in the *Journal of Employee Ownership, Law and Finance*

[6]See also Corey Rosen and Michael Quarry, "How Well is Employee Ownership Working?" *Harvard Business Review*, Sept.-Oct. 1987.

[7]Douglas L. Kruse and Joseph R. Blasi, 1994, "Employee Ownership, Employee Attitudes, and Firm Performance: A Review of the Evidence," mimeo. The study included ESOPs, cooperatives, and other forms of employee ownership. Note, however, that the studies reviewed were not uniformly rigorous in their survey methodology.

dence was found that employee-shareholders want to take total control of firms and dominate decision-making.[8] In firms with employee ownership, the studies did not show significantly higher employee participation in decision making than in conventional firms, either at the job level or at the management level.

The studies left some key questions unanswered. The research fails to reveal either an optimal level of employee ownership or the level at which it could become dysfunctional. While the studies often associated employee ownership with better performance, they did not establish that employee ownership, rather than some other characteristic of the firm (such as management quality, company policies, etc.) was the reason for the improvement. Similarly, although employee participation in decision making was positively associated with employee ownership, the studies did not conclusively identify the optimum type, level, extent, or range of such participation. The research has only begun to probe the range of human resource policies that could prove to be positive complements to employee ownership.

A 1994 study (limited to U.S.-based ESOPs) attempted to compare the investment performance of ESOPs and other non-diversified employee benefit plans against diversified plans (that is, plans that invest broadly rather than concentrating their investments in employer shares).[9] This report, covering the 1981-1990 period, concluded that "overall the returns of non-diversified plans were significantly higher than the returns of diversified plans," though the results appeared to be closely correlated with the size and the trading status of the sponsor company's shares (ESOPs sponsored by larger public companies fared much better than those in smaller, privately-held companies), and by the primary industry sector in which the sponsor operated (ranging from a low correlation in mining to a high correlation in transportation, communication, and public utilities). The research also found that "higher degrees of employee ownership led to higher returns among ESOPs in small public companies, and this held true even on a risk-adjusted basis."

FACILITATING PRIVATIZATION AND OTHER REFORMS

ESOPs are increasingly being used to create broad-based ownership and to build support for privatization in a variety of circumstances: in developing countries; in state-dominated and transition economies undergoing restructuring; in economies where there is a desire to dilute concentrated patterns of private ownership; in state-owned enterprises where workers are opposed to privatization because of possible job losses; in countries where there is political resistance to external investment; and where governments want to anchor some of the productive assets of multinational corporations. The objective of facilitating privatization takes on particular importance in developing countries, where ESOPs have been essential to advancing privatization by creating political support for reform and alleviating labor concerns. Furthermore, ESOPs' usefulness in resolving the fundamental problem of how to provide workers a stake in economic development has led to their growing appeal.

The ability of ESOPs to involve workers in the overall economic development process and to overcome opposition from organized labor (e.g., Côte d'Ivoire, Guyana) ensures their growing importance in the developing world. Governments can easily utilize ESOPs; a selling government can extend an ESOP credit, sell the enterprise in stages, and in other ways help employees to purchase shares. In low-income settings — where privatization is particularly difficult to launch — employee ownership schemes provide a natural focus for commencing the process even though few proceeds might be realized.[10] In other settings, employees provide a ready market for shares, thus accelerating the pace of privatization.

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[8]See also Myron S. Scholes, "Stock and Compensation," *Journal of Finance*, July 1991, pp. 804-806, who notes that even when ESOPs are set up as a result of union-negotiated stock-for-wage concessions, giving workers an immediate stake in the company's financial performance, workers have rarely questioned the management of the company as long as the value of their stock is preserved. This study found that management performance also tends to improve under such circumstances. Although "employees who owns shares ... have little interest [in challenging the decisions of upper management] unless these decisions directly affect their employment .... these employees exert indirect pressure on upper management, who know that the firm's owners are working around them, to maximize value. This is a form of partnership organization and, as such, acts as a powerful control mechanism."

[9]Professor Michael A. Conte, "Rate of Return on ESOPS and Similar Plans," U.S. Department of Labor contract #J-9-P-0051 (July 27, 1994).

Employee ownership can help soften the impact of privatization and give employees an incentive to assist with the restructuring effort that often accompanies successful privatizations. The inclusion of employees can affect the extent to which restructuring (and/or marketization) occurs in conjunction with privatization, and can help privatized companies retain employees with firm-specific skills.[11] Workers, for their part, gain a stake in the firm whose future they assist in creating.

ESOPs grow in importance in economies undergoing worker-led reform (e.g., Poland),[12] and where the interests of workers have historically been a key focus in politics (e.g., Russia, Ukraine). In the former Soviet Union (FSU), ESOPs have become a natural component of privatization because of their usefulness as a tool to ensure that "insiders" are included in privatization. Worker ownership has emerged as a common aspect of privatization efforts in each of the FSU republics (see Annex 1).[13]

An employee ownership component of privatization has also been utilized: where the political acceptance of external investment remains unsettled, as in China's ongoing marketization efforts; where an interest exists in diluting a controlling interest taken up by others, such as managers; or where the absence of alternative buyers makes it necessary to generate a domestic demand for shares (Hungary). Employee participation can also broaden the base of potential stock market participants, providing a stimulus to emerging capital markets.

ESOPs have also been used as a first step in privatization strategies (e.g., US)[14]; as a component of phased privatization programs (e.g., Pakistan); and as a means to decentralize economic power. In Chile, for example, including a component of employee ownership in privatization strategies has helped ensure that privatization techniques do not foster concentrated patterns of private sector ownership and economic power. Furthermore, employee ownership can make companies more attractive to foreign investors because the workers' stake in the company is perceived to reduce the risk of renationalization.[15]

RAISING MONEY TO MEET CORPORATE NEEDS

While ESOPs broaden ownership and facilitate privatization in developing countries, ESOPs in developed countries achieve a variety of corporate financing goals. These goals typically include estate (and liquidity) planning, mergers, acquisitions, divestitures, and recapitalizations. A corporation either issues shares and sells them to the ESOP or, more commonly, uses an ESOP to acquire outstanding shares. These shares are held for employees, with the debt incurred by the ESOP to purchase the shares

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[10]"Costs in lost revenue, usually low to begin with, are outweighed by the benefits of such schemes." Sunita Kikeri, John Nellis, and Mary Shirley, *Privatization: The Lessons of Experience*, World Bank, Washington DC, 1992, p. 60.

[11]See Smith, ibid.

[12]Poland's mass privatization program, introduced in July 1990, included two principal privatization strategies: sales to foreign investors and initial public offerings on the Warsaw stock exchange. By July 1994, however, only 24 initial public offerings and 60 sales to foreign investors had been completed. But a provision added almost as an afterthought that permitted the "liquidation" of medium-size companies via employee ownership and "employee leasing" resulted in more than 1,000 privatizations. See Lucja Swiatkowski Cannon, "Poland's Privatization is a Mess," *Financial Times* (London), Sept. 9, 1994.

[13]Soo J. Im, R. Jalali, and Jamal Saghir, "Privatization in the Republics of the Former Soviet Union: Framework and Initial Results," Private Sector Development and Privatization Group (CFSPS), World Bank, Washington DC, 1993. See also Joseph R. Blasi, "Ownership, Governance and Restructuring," in Ira W. Lieberman and John Nellis (eds.), *Creating Private Enterprises and Efficient Markets*, World Bank Private Sector Development Department, Washington DC, 1994.

[14]For example, as part of a government-provided financial infusion provided to a U.S. Government-owned railroad (Conrail) in 1979, the company was required to establish an ESOP holding 15 percent of the company's shares. For several years, the company operated under a management contract with 15 percent ESOP ownership and 85 percent government ownership pending its privatization (when employees sold their shares). ESOPs are also the key ingredient in U.S. privatization policy, which also proposes guaranteed employment for a limited period and offers outplacement service. See *Federal Employee Direct Corporate Ownership Opportunity Plan (FED CO-OP) Blueprint for Implementation*, US Office of Personnel Management, Washington DC, 1987.

[15]Rolf J. Luders, "Chile's Massive SOE Divestiture Program, 1975-1990," paper presented at the Conference on Privatization and Ownership Changes in East and Central Europe, World Bank, Washington DC, June 13-14, 1990.

being repaid by the corporation, largely out of its future earnings (that is, the employees' ESOP stake is "self financed").

ESOPs provide an "inside" market for otherwise non-traded shares. Since ESOPs have no independent financial capacity (that is, collateral or cash flow), they act as a financing conduit — for example, for borrowing funds to buy shares from a retiring founder, with the company thereafter making regular contributions to the ESOP to repay the debt. Whether the seller holds the note (thereby acting as both seller and lender) or the funds are borrowed from an outside lender, it is the corporation, not the ESOP, that is responsible for repaying the debt, though the ESOP may well provide its note to the lender.

ESOPs, in a similar fashion, can help to finance a divestiture or to raise capital for corporate expansion. In the usual case, a divestiture would be structured to transfer ownership to a previously unrelated party or perhaps to the managers (for instance, via a management buyout). In the case of an ESOP-financed divestiture, an ESOP is typically established by the acquiring company to hold the newly acquired shares, with the sponsor company making contributions to the ESOP to repay the acquisition debt. In the more typical case, a capital expansion would be financed either for the benefit of current shareholders or for the benefit of outside providers of financial capital. In the case of an ESOP-financed corporate expansion, an ESOP uses a company-secured loan to purchase the company's newly issued or treasury shares, with the company repaying the debt from its future earnings.[16]

In developing countries, this corporate finance objective may prove useful in attracting foreign investment in local corporations. With ESOPs serving as a government-facilitated exit-mechanism, foreign investors could be reassured about the liquidity of their shares while addressing domestic concerns about the ongoing foreign ownership of such investments. For example, by encouraging ESOPs as part of a country's institutional structure, potential investors would have available to them an "exit" mechanism that could enhance the liquidity of their investment capital. This enhanced liquidity, in turn, could assist in reducing the perceived investment risk, thereby lowering the minimum returns required by investors, potentially increasing overall capital in-flows. At the same time, the encouragement of such exit techniques could assist in transforming needed foreign capital into broad-based indigenous ownership.

Clearly, ESOPs meet the demands of many a company and government. Remaining are the issues of how to financially structure and design ESOPs to meet a wide variety of circumstances. The following chapters discuss alternative approaches to the implementation of an ESOP. ■

[16]See Lawrence Bader and Jenny Hourihan, *The Financial Executive's Guide to ESOPs*, Salomon Brothers Asset Allocation Group, New York, 1989.

CHAPTER II. FINANCING ALTERNATIVES

The success of ESOPs in extending ownership, enhancing enterprise performance, facilitating privatization, and raising money for corporate purposes depends on adherence to certain principles in the financing, design, and operation of the plan. This chapter discusses the various ways that ESOPs both broaden and transfer ownership and how they can be used to raise funds to finance corporate expansion. The discussion covers cases where government incentives support ownership transfer via ESOPs.

BROADENING OWNERSHIP AND RAISING CAPITAL THROUGH SELF-FINANCING

The essence of an ESOP financing scheme, whether funds are generated to buy outstanding shares for employees or to raise money for corporate expansion, relies upon productive assets that pay for themselves out of future corporate earnings. Repaying the debt incurred to purchase shares for the ESOP transforms that company-secured debt into company equity for employees.

There are three basic types of ESOP financing mechanisms: (1) employee purchase schemes **financed out of employee compensation** (such as payroll withholding or contractual bonuses); (2) profit-sharing schemes **financed with employer contributions** from company profits, and (3) ESOPs **funded with external loans** repaid out of future corporate earnings. To the extent that an ESOP is financed with future corporate earnings, it is **self-financed**. To the extent that it is financed with borrowed money, it is **leveraged**.

These approaches are not mutually exclusive. A leveraged ESOP that borrows funds either to acquire newly issued shares (see Figure 3) or to finance a transfer of shares from existing owners, including a government (see Figure 4), may also be self-financing if the debt is paid out of corporate earnings. In practice, as discussed below, ESOPs are often funded through a combination of these approaches.

WORKER-FINANCED ESOPS

In both the developed and the developing world, the popularity of plans funded by employee concessions is increasing. Under this approach, employees agree to take less cash out of a company (in the form of pay and benefits), and the company agrees to use those funds to buy shares for employees (see Employer-Financed ESOPs, below). Thus, a combination of employee wage restraint and future company earnings creates the cash flow needed for employees to purchase their ownership stake. As more cash becomes available to service ESOP-related debt, the company's creditworthiness is enhanced. Employee concessions formed the basis of two important ESOP initiatives, one involving the employee purchase of a controlling interest in United Airlines (see Box 2), the other involving the privatization of the Allied Bank of Pakistan (see Box 3).

Sources of employee funds include:

- Payroll withholding deductions,
- Bonus reinvestment (more common in countries that routinely pay employees for a 13th month),
- Profit sharing plans,
- Dividends paid on ESOP-held shares,[17]

[17]Dividends paid on ESOP-held shares have been used both to buy new shares and to repay ESOP debt. For example, under US law, a special class of high-dividend, convertible preferred shares can be used to fund an ESOP, thereby enabling the sponsor corporation to accelerate loan repayment by declaring tax-deductible dividends on this special class of ESOP shares and using those dividends to repay ESOP debt. US law generally limits this tax advantage to reasonable dividends, disallowing those that could not be paid on a recurring basis.

Figure 3 - Leveraged ESOP for Acquiring Newly Issued Shares

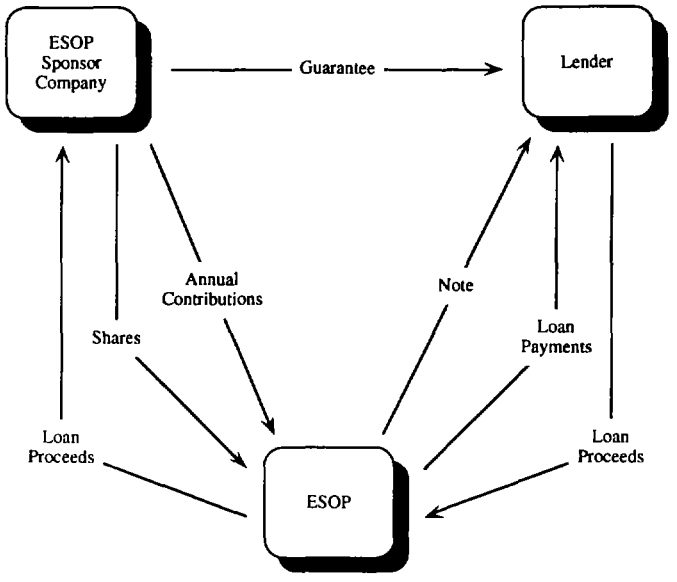
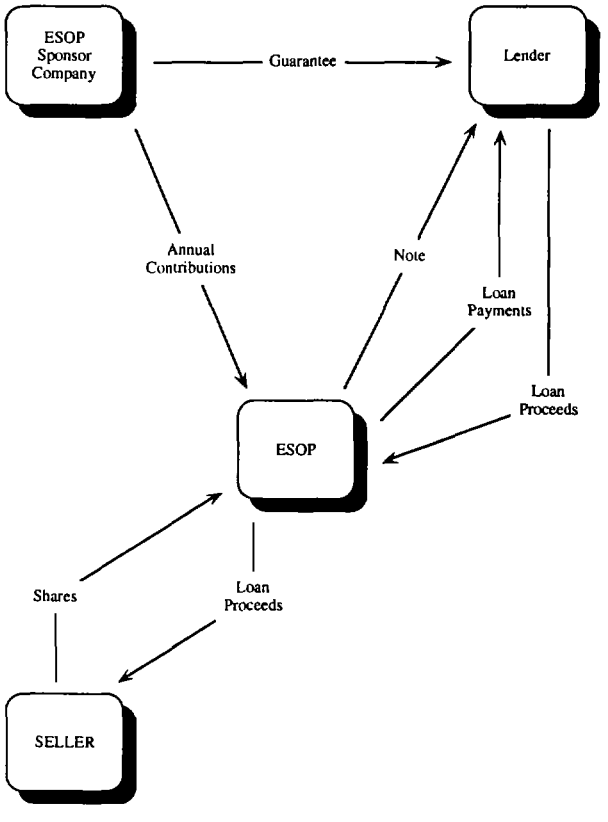


Figure 4 - Leveraged ESOP For Transferring Ownership of Shares



- Severance funds (meaning the reserves set aside to fund severance liabilities or where governments allow advance payments or loans against such payments),[18]
- Pension funds (to the extent that such funds are not exposed to inappropriate levels of risk),
- Employee concessions (such as changes in compensation and/or work rules).

EMPLOYER-FINANCED ESOPS

Employers finance ownership-transfer, as opposed to capital-raising ESOPs by making contributions to an ESOP of either shares or cash. In some countries (e.g., Hungary, Jamaica, United States, United Kingdom), such contributions qualify for a tax deduction. An employer contributes shares to an ESOP and can then deduct the fair market value of those shares. Employers can also tax shelter the principal payments on a conventional non-ESOP loan by making conventional non-deductible principal payments and simultaneously contributing shares of equal value to an ESOP for which a tax deduction is typically allowed.

Employers use ESOPs to expand capital without external borrowing by contributing newly issued or treasury shares to an ESOP and, under the tax law of many countries, claiming a tax deduction for the value of the shares. This increases the net worth of the company by the value of the tax deduction. Absent improvements in enterprise performance or adjustments in compensation, however, this increase may not benefit other shareholders. A company's net worth also increases when the cash it contributes to an ESOP buys treasury shares. On the other hand, where shares contributed to or bought by an ESOP are acquired on the open market, the company's cash and equity are both *decreased* rather than increased, since this ESOP expense represents cash flowing out of the company, much the same as cash wages.

ESOPS FINANCED WITH EXTERNAL LOANS

The leveraged ESOP — the best-known ESOP financing model — requires the sponsor company to borrow funds to acquire a block of its shares for employees. These shares can be either newly issued shares, treasury shares (where permitted), or outstanding shares. The ESOP purchases the shares with the borrowed funds and then the ESOP-sponsoring com-

[18] Quite commonly, this severance payment obligation is funded not with case but via an accounting entry on the balance sheet of the employer or as a contingent liability of the government. The exchange of this debt for shares can provide a means for financing employees' shares (as in El Salvador).

Box 2. United Airlines ESOP Buy-Out

A union coalition-led ESOP buy-out of United Airlines in July 1994 converted this commercial airline into the largest majority employee-owned company in the developed world (79,000 employees, with 56,000 participating in the ESOP). The purchase took the structure of a leveraged buy-out financed largely by a concessions-for-equity swap. Employees initially acquired 55 percent of the outstanding shares of this listed company via a tender to current shareholders (who received cash plus one-half share for every share they previously held).

In support of the buy-out, employees agreed to a 5-year package of wage and benefit concessions valued at approximately $5 billion, with the money saved paying off the ESOP-related debt. Various worker groups agreed to different schedules of concessions (for example, pilots took a 15.7 percent pay cut, while machinists took a 9.7 percent cut and gave up a scheduled pay increase). Work rule changes and a no-strike clause formed part of the agreement. Unions obtained veto power on the sale of certain operations. Pilots received approximately 46 percent of the employee stake, machinists 37 percent, and non-union employees 17 percent. The flight attendants' union declined to participate.

The newly structured company has a 12-person board of directors. Each of the three participating employee groups appointed one director (two union and one non-union). Five members, including the chief executive officer, were appointed by the previous board, and these live in turn selected four independent directors jointly agreed upon by management and labor.

pany pays off the debt with contributions to the ESOP and/or with dividends paid on shares held by the ESOP. As the loan principal is paid, the portion paid off is reflected in shares credited to employees' individual accounts. This approach enables employees to acquire a block of shares at an initial price, with the purchase price paid — at least in substantial part — with the future earnings of the enterprise. This same structure can be used to finance a transfer of shares (e.g., for an ESOP to acquire outstanding shares from a company's founder) or to finance new capital (e.g., with an ESOP used to acquire newly issued shares).

Such debt-based transactions have been used in developed countries to finance expansion and other corporate goals, and in developing countries to finance employee participation in privatization. Leveraged ESOPs, however, raise concerns about both financial efficiency and dilution. For example, non-ESOP shareholders have argued that the servicing of ESOP debt represents an additional, earnings-eroding expense to the company unless offset by reductions in employee's pay or benefits.

From the perspective of these other shareholders, a key to the financial efficiency and economic viability of the ESOP depends on fitting ESOP financing into a total compensation package. One can avoid earnings dilution if the new capital raised by an ESOP produces the same or a greater rate of return as existing capital and if there is no incremental ESOP-related cost (generally characterized as a compensation cost). In legal systems that allow more than one class of shares, issuing preferred shares at a premium, coupled with a program for repurchasing common shares, can also help avoid dilution (that is, by reducing the number of shares outstanding). To the extent that implementing an ESOP boosts productivity, that too helps offset potential dilution. Also, to the extent that ESOPs do not impose significantly increased cash flow requirements on sponsor companies or alter their capital structures materially over extended periods, security rating agencies in developed countries view as benign ESOPs established by healthy companies.[19]

Whether or not encouraged by fiscal or other incentives, leveraged ESOPs — because they involve debt — entail greater risk than non-leveraged approaches (see Broadening Ownership through Fiscal Incentives, below). Where the sponsor company secures and services the debt, employees incur no personal liability, but the company must be sufficiently healthy to afford such debt service obligations. Firms that need substantial restructuring or are struggling in distressed economic environments may find this approach unwise. Weak companies (private or privatizable), do not make good candidates for leveraged ESOPs in the absence of an indication of imminent financial strengthening, either from an influx of outside equity or from a willingness of employees to adjust their claims on company revenues.

In developed economies (such as the United States and the United Kingdom), ESOP financing is frequently used to create a market for non-traded shares. By providing an "in-house" market for such shares, ESOPs often provide an alternative to an outright sale of a company. Also, a sale of shares to an ESOP can serve as an alternative to the widely-permitted tax-free exchange of shares whereby shareholders are commonly allowed to trade their shares for those of another company (typically a publicly traded company), deferring any capital gains (and/or transfer) tax until such time as the shares are sold.

[19]See Bader and Hourihan, op. cit.

Box 3. Allied Bank of Pakistan

The 1991 partial privatization of Allied Bank of Pakistan took place via an ESOP scheme combining employee purchases and corporate financing. Allied's employees initially made concessions and acquired a controlling 26 percent tranche of shares purchased in part with their personal savings, with an option to acquire another 25 percent tranche the following year. The purchases were funded via (a) two pay increases (of 25 percent and 20 percent) paid out of increased bank earnings (profits increased 268 percent in the year following sale of the first tranche to employees); and (b) a 10 percent dividend on those shares. Also, under Pakistani law, banks may grant employees interest-free loans based on their salary level. The pay hikes, therefore, qualified Allied Bank employees for larger loans with which to acquire shares. Although characterized as an employee purchase, this purchase of shares was substantially financed via increased company profits — first paid out as employee salaries and then paid over to the seller (the government). In the first year following privatization, employment at the bank increased from 7,200 to approximately 8,000.

An ESOP analog to this customary tax deferral and diversification mechanism is permitted under U.S. and U.K. tax policy whereby shareholders are allowed to sell their shares to an ESOP and reinvest their proceeds tax-free, thereby diversifying and enhancing share liquidity without the need to trade substantially all of their shares in order to qualify for this advantage (as is typically required under the rules governing tax-free exchanges).[20]

In addition, ESOP financing provides a ready mechanism for divesting subsidiaries or divisions. For example, a company can spin-off a division by having the new entity purchase the division via a note given to the parent company. Also, ESOP financing has become commonplace in deregulated industries in developed countries (such as transportation) and in industries newly impacted by global trade or by new technologies (such as steel production). An ESOP provides a means whereby employees can acquire a block of shares, often via stock-for-compensation swaps, while providing the company with a means for reducing fixed labor costs.

In addition, such an arrangement can result in the creation of a substantial block of "inside" shareholders. ESOP financing has also been used to acquire shares that are considered undervalued. Fostering a cadre of knowledgeable employee-shareholders also may provide modest protection against hostile takeover attempts, enabling the company to focus on longer-term projects and research and development. On the other hand, employee-owners (and/or an ESOP trustee) may choose to vote their shares in favor of a tender offer, possibly facilitating a takeover. Employee ownership financing has also become a common component of privatization structures, particularly in political environments where resistance by company insiders (managers and employees) poses a potential barrier to progress and where cash-poor employees otherwise lack the financial capacity to invest (as in Russia and Poland).

FINANCING PRIVATIZATION

In a privatization context, self-financing ESOP schemes combined with government incentives such as share grants or discounts, may facilitate the acquisition of shares by cash-poor workers. Given the shortage of public revenues in developing countries, however, the challenge will be to develop approaches that do not require significant government subsidies. Despite the drawbacks associated with governments offering fiscal incentives, a number of countries have nevertheless chosen this route to encourage employee ownership, as illustrated in the cases below. While the World Bank does not typically support government subsidies on a regular basis, a one-time incentive to facilitate privatization may be justifiable and is not necessarily a fiscal drain if privatization would not have moved ahead otherwise. Incentives (such as tax breaks) to encourage companies to set up ESOPs are, however, a more problematic use of fiscal revenues.

Particularly where the costs of delaying privatization are mounting due to asset deterioration, waning investor interest, and the coalescing of opposing forces, the policy benefits of employee participation could outweigh the immediate costs, allowing privatization to proceed without costly and time-consuming restructuring. On the other hand, if improperly designed, an employee participation component can have a negative effect. Poor design can lead to excessive labor costs and even politicization of the workplace, impeding needed enterprise restructuring and eroding the interests of other potential investors.[21]

If employees become shareholders as part of privatization and are then laid off during post-privatization restructuring, their continued ownership could become problematic. To guard against this, a US-based privatization program suggested that, as part of the restructuring accompanying privatization, redundant employees be allocated extra shares via an ESOP as a component of their severance.[22]

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[20] Under U.S. law, this tax-free reinvestment requires a minimum post-sale 30% ESOP holding, while U.K. law requires at minimum 10%.

[21] Blasi, 1994, suggests there is little evidence that employees' salaries in the employee-ownership dominated Russian privatization program bear any significant relationship to the capital investment needed by privatized enterprises. A survey found that since 1991, post-privatized firms have cut employment by 21 percent and that managers seem prepared to cut more once a comprehensive social safety net is in place.

[22] See "FED CO-OP" (Federal Employee Direct Corporate Ownership Opportunity Plan), 1987.

GOVERNMENT VERSUS COMMERCIAL LENDING IN PRIVATIZATION

When privatizing state-owned enterprises with a debt-financed ESOP, the debt could be held either by the government — acting as both seller and lender — or, when the government wants to divest itself completely, by a commercial bank. The government or the commercial lender typically accepts a company guarantee of the debt extended to acquire the shares sold to the ESOP. The company (the newly privatized enterprise) applies a portion of its earnings to repay the ESOP debt.

Private banks finance privatizations mainly in OECD countries; in developing countries they seem reluctant to do so either because of a lack of resources or because of the risk of committing limited funds to companies with poor performance records and high debts. Private banks may perceive the risks to be greater when loans transfer significant ownership to employees (where concerns might arise concerning control, management expertise, etc.), rather than, say, to finance new, revenue-enhancing physical capital.

The risks of financing privatization also concern government-owned banks. In developing countries, these banks are themselves often leveraged and thus in danger of defaulting on their own loans if the privatized company cannot service its ESOP debt. Privatizing governments might wish to consider the consequences of default on such debt, including the possibility that the company could revert to state ownership, as happened in Chile's first round of privatizations (see Box 4). Leverage, while helpful, does involve risk.

Box 4. Chile - The Risks of Leveraged Privatization

Chile offers an example of the perils of financial leverage, whether or not utilized in conjunction with ESOPs. During Chile's first round of privatizations (1974-79), the government used bidding to divest, on credit, its controlling interest in many state-owned enterprises. Terms generally included a down payment of 10-20 percent with a one-year grace period, followed by a 5-7 year repayment period at a real interest rate of 8-12 percent, with the credit secured only by the shares being sold. Although granting credit to facilitate these sales brought the government a high price for the shares, that higher price was accompanied by higher risk, including the risk of reversal. Many of these highly leveraged firms took excessive risks to service their debts, and during the recession of the early 1980s, this thin equity base contributed to 70 percent of these companies becoming insolvent. As a result, many privatizations were reversed, with the government regaining control of a number of enterprises when their lender banks (many of which were also privatized with leveraged debt) were renationalized (see Kikeri, Nellis, and Shirley, op. cit., p. 67).

In the second round of privatizations (1984-89), the government sold controlling tranches of shares on a cash basis only to highly solvent parties (often to joint ventures formed by local investors and foreign interests). Payment frequently included a debt-equity swap whereby Chilean foreign debt was purchased and traded for shares. A portion of that debt was attributable to the first round of privatizations and was trading internationally at about 60 percent of face value. Extensions of credit, under this new approach, were reserved for employees and small investors.

Second round privatizations occurred in two stages. In stage one, "popular capitalism" was used to reprivatize large financial institutions, including newly established pension fund administration companies (AFPs). Offerings to the public were encouraged through favorable credit terms, including a five percent down payment, a 15-year repayment period at zero percent interest, and a generous tax credit. Given the projected dividend stream, taxpayers viewed the shares as virtually free. A limit of approximately US$5,000 per person was placed on the amount of shares each person could buy under these favorable conditions. The popular capitalism approach financed two large AFPs, Provida (60 percent) and Santa Maria (49 percent), with the balances acquired, respectively, by Bankers Trust (via a debt-equity swap) and Aetna Insurance Company. Also using popular capitalism, a few banks were sold directly to certain interest groups (e.g., to a group of miners).

In stage two, the government relied largely on "labor capitalism," "institutional capitalism," and "traditional capitalism." With regard to labor capitalism, the government encouraged broad-based employee ownership (see Box 10). To promote institutional capitalism, the government sold shares to institutional investors and to the AFPs, largely as a means for expanding stock ownership and developing capital markets. The AFPs were limited to investments approved by a government-sponsored Risk Classification Commission. With respect to traditional capitalism, the government auctioned small- and medium-size blocks of shares on the stock exchange (see Dominique Hachette and Rolf Luders, *Privatization in Chile - An Economic Appraisal*, International Center for Economic Growth, San Francisco, 1993).

EQUITY INVESTORS

In countries with underdeveloped capital markets and a general lack of liquidity, governments often try to attract foreign capital to help finance privatization. But where foreign investors inject equity into a company, as happened in the early privatizations in Hungary (see Box 5), difficult issues can arise concerning the ownership stakes of the various participants, particularly when a government wants to encourage domestic ownership. On the other hand, where the employees' stake is self-financed, the claim that employee-owners make on a sponsor company's cash flows and collateral could pose an unacceptable burden on investors' anticipated financial returns and/or on their plans to apply the company's financial capacity to other purposes.[23]

Employee ownership can become a contentious issue among privatization policymakers, with opponents fearful that employee ownership may decrease investor interest.[24] It is possible, however, that an element of employee ownership can enhance receptiveness to foreign investment where a workforce regards privatization with apprehension or suspicion.[25] In addition, employees' interest in owning shares could provide a positive signal to other potential investors, particularly where management employees are also involved as investors.[26]

In Hungary, early government efforts to attract outside investors have given way to ESOP incentives designed to broaden ownership among workers on a partially self-financing basis.

Workers unaccustomed to the long-term vagaries of equity ownership may have difficulty understanding the impact of corporate losses, declining share values, and a lack of dividends, particularly where they envisioned an immediate ownership-facilitated increase in their standard of living. Similarly, employees' personal perceptions of the acceptability of risk may differ from those of investors (or of policymakers intent on shifting commercial risks from the public to the private sector). Employees may be reluctant to trade off the relative certainty of current income for possibly illiquid capital accumulation and uncertain capital appreciation and dividends, at least in the absence of some inducement (such as an enforceable no lay-off agreement).[27] This suggests that those wishing to promote worker ownership need to consider educating employees about those issues involving share ownership.

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[23]Partial divestment by investors after a period of time has, in fact, been made an obligatory feature of the privatization sale and purchase agreement in a few instances. In privatizing its partially state-owned banks, Mexico provided an incentive to core investors while also requiring that they divest a portion of their shares after a prescribed period. Similarly, Venezuelan banks were sold by the government with a covenant of sale requiring that, over a 3 to 5 year period, shares would be offered to both employees and the public. In Indonesia, New Zealand, and Togo, state-owned enterprises have been sold to foreigners with the stipulation that a certain amount of shares gradually be sold to small investors through the stock market. Kikeri, Nellis, and Shirley, op. cit., pp. 47 and 65. See also Shann Turnbull, "Flaws and Remedies in Corporatization and Privatization," *Human Systems Management,* v. 12, no. 3, 1993.

[24]Note, however, the results of surveys of Russian managers (Blasi, op. cit.), which suggest that, in Russia's employee ownership-dominated privatization program, it is not ownership by rank and file employees that poses the barrier to investment. Instead, it is a combination of factors that cause investors to hesitate, including the desire of current managers to gain and retain a controlling stake, plus a variety of unmet institutional needs such as undeveloped capital markets, a lack of reliable accounting systems, poorly educated managers and an uncertain commercial and political environment, with constantly changing laws and regulations. Note also three survey conclusions: (1) "the overwhelming conclusion about employee ownership is near complete passivity on the part of the Russian worker," (2) "top managers were almost uniformly negative in their evaluation of broad-based employee ownership. They consider majority employee ownership to be a transitional phenomenon"; and (3) "when asked what the total optimal rank-and-file employee stake should be, general directors indicated roughly 15 percent. This is an interesting coincidence, given that the US average for rank-and-file employee ownership stake is 15 percent in public companies with employee ownership." (see also Maria Jarosz. 1994. *Employee Owned Companies in Poland*. Institutute of Political Studies, Polish Academy of Sciences. Warsaw, Poland.)

[25]See Smith, 1994.

[26]In management (or management/employee) buyouts in developed countries, it is common practice for investors to insist that managers gain an ownership stake on terms where the managers are significantly at risk, including financing terms involving substantial personal liability, thereby ensuring both (1) their personal at-risk commitment, and (2) the reliability of the company-related financial information they provide.

[27]See Blasi, 1994, who notes that some general directors of privatized Russian enterprises report that firings and layoffs, not employee ownership, are among the reasons some workers are being more careful about the way they work.

Box 5. Privatization in Hungary

Early Hungarian privatizations were criticized by some Hungarians for transferring ownership largely to foreign investors. Where employees were included, that participation often heavily favored senior management. Hungary's original "market-based" policy of waiting for a demand for shares to develop has since shifted to stimulating that demand, with revenue generation taking a secondary role to the goal of expanding domestic participation. The government's ESOP program is one component of an ongoing initiative to accelerate privatization by including employees on a self-financed basis. ESOP organizations are allowed to purchase a company's shares with payments spread over a 15-year period, with an optional 3-year grace period of interest payments only. The interest rate is 3 percent plus the intermediary bank's 4 percent margin. Banks may lend up to 85 percent of the value of the shares. A required down payment of 2 percent, 15 percent, or 25 percent is based on a formula linked to the average price per participant for those shares proposed for ESOP financing. Legislation enacted in 1992 allows an ESOP-sponsoring company to claim a tax deduction for up to 20 percent of its pre-tax profits to fund an ESOP or to repay ESOP-related privatization debt. In 1993, ESOPs were used in the privatization of approximately 130 Hungarian companies.

Box 6. US Financing Incentives for ESOPs

Since 1973, the US has enacted 25 pieces of Federal legislation designed to encourage ESOPs, including loan programs, loan guarantees, trade assistance programs, and a range of fiscal incentives directed at ESOP participants, sponsor companies, lenders, and shareholders selling to ESOPs. As in other employee benefit plans, ESOP participants are allowed a deferral of tax on employer contributions to their individual ESOP accounts. Sponsor companies are allowed an annual tax deduction for the expense of funding an ESOP, up to 25 percent of participants' payroll for leveraged ESOPs. Where those funds are applied to repay an ESOP loan, the sponsor is able to deduct the expense of both interest and principal payments, treating both as an expense of providing an employee benefit. Dividends paid on ESOP-held shares also qualify for an employer tax deduction where those dividends are paid out to employees or are applied to repay debt used to acquire those shares. Commercial lenders are encouraged to finance ESOPs via a provision permitting them to deduct 50 percent of the interest earned on certain ESOP loans. Shareholders in unlisted companies are encouraged to use ESOPs as an "internal market" for their shares by a provision permitting a deferral of capital gains tax on proceeds realized on the sale of shares to an ESOP, provided that, following the sale, the ESOP owns a minimum 30 percent of the company.

Box 7. Incentives for Privatization in Germany

The Treuhandanstalt, Germany's privatization agency, was charged with privatizing all government-owned companies in the former German Democratic Republic. Approximately 20 percent — over 2,000 privatizations — have been accomplished via management buy-outs, primarily in service industries and in small and mid-sized companies. Sixty percent of such buy-outs include some form of state-assisted financing. Approximately 10 percent of those buy-outs include an employee ownership program. The largest such company is Industrie Montage, a construction company with 1,350 employees, 990 of whom participate in the employee ownership arrangement. Venture capitalists acquired 49 percent of the shares. The government of Saxony guaranteed a loan to facilitate employee share purchases. A special law allows loans to be repaid out of future company profits and provides that workers pay no tax on any income on their equity.

BROADENING OWNERSHIP THROUGH GOVERNMENT INCENTIVES

A number of countries, including the US and Germany, pursue proactive policies to make employee ownership attractive and flexible enough to address a broad range of common corporate financing needs. In the US (see Box 6), ESOPs enjoy various tax incentives. In Germany (see Box 7), privatization occurs through a combination of employee share purchases (via a government-guaranteed bank loan), state-assisted financing, tax incentives, and external investment.

Employee-targeted share grants and government-subsidized discounts often arise in the context of privatization. Both have advantages and drawbacks. Share grants (shares given free to employees) ensure a high rate of participation, make shares available to low-paid employees, and accelerate the privatization process. In certain cases (that is, if other buyers are available), however, they have a real fiscal cost and may evoke no employee commitment to the company. Discounts on employee shares are a common feature of privatization in Poland, South Korea, Chile, Jamaica, and Russia (Box 8), helping to increase the political acceptance and pace of privatization. Yet unless the discount is large, discounts might not stimulate the desired level of employee ownership among cash-poor workers. In such cases, profit sharing to acquire employer shares arises as a possible solution.[28]

While employee-directed discounts can generate revenue (compared to free grants) and help make employee participation more affordable, they can also, unless combined with a lock-in mechanism, encourage speculation and turnover by employees. This speculation would, in effect, encourage employees to "liquidate the discount" by selling the shares. Although employee discounts may garner political support for privatization, they may have little or no long-term ability to promote either sustained employee ownership or broad-based capital ownership. Also, unless discount sales are combined with individual share purchase limitations, they can be monopolized by high-income employees.

In sum, ESOPs can be used as tools to increase worker ownership as well as to raise capital. Capital obtained through ESOPs may be available on advantageous terms where tax advantages are extended to ESOPs in certain countries. Wage restraint can be used to help finance an ESOP funded from future company earnings as labor costs are contained and the company has an increased ability to service the ESOP debt incurred to purchase the shares. As an alternative to such worker financed ESOPs, a company can itself contribute either shares or cash to the ESOP; in some countries such a contribution is tax-deductible. In such countries, contributing newly issued or treasury shares and then claiming a deduction makes it possible to increase the net worth of the company by the value of the deduction.

Companies that use external loans to finance ESOP share purchases must be of sufficient strength to meet their debt obligations. Governments can use ESOPs to help encourage employees of SOEs to support potential productivity improvements accompanying privatization. When privatizing, governments can either finance ESOPs directly, or turn to commercial banks to provide loans.

The level of understanding of workers on issues relating to stock ownership should be enhanced for an ESOP to work effectively. Pro-active policies used to promote employee ownership include: tax incentives, employee share purchases via government-guaranteed loans, state-assisted financing, share grants, government-subsidized discounts, and the encouragement of profit sharing to acquire shares. As discussed in Chapter III, Design Issues, any fiscal incentives should be carefully drawn to encourage broad-based employee participation and to ensure that the bulk of the benefits are not monopolized by a few participants. ■

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[28]The amount of profits shared can be discretionary or formula based, the sharing of these amounts with employees can be individually or collectively based, and the receipt of benefits can be immediate or deferred (for example, with funds held in a trust for later distribution). Where profit-sharing amounts are invested in employer shares and receipt is deferred, such schemes resemble unleveraged ESOPs in many ways. See Barbara Lee, "Should Employee Participation Be Part of Privatization?" Country Economics Department, Public Sector Management and Private Sector Development, World Bank, 1991. The prevalence of employee ownership in the US is attributable not only to ESOPs but also to employee share purchase arrangements, profit-sharing plans, and more recently, to tax-favored "cash or deferred profit-sharing plans." See Joseph Blasi and Douglas L. Kruse, "The New Owners: the Mass Emergence of Employee Ownership in Public Companies and What It Means to American Business," Harper Collins, New York, 1991.

Box 8. Incentives for Privatization

Poland:
The government allows employees to purchase up to 20 percent of the shares of privatized companies at a 50 percent discount (provided total employee purchases do not exceed one year's average industry salary). The government encourages managers and employees to form joint stock companies and lease the liquidated assets of the enterprise provided that (a) at least 50 percent of the employees want to establish such a stock company, and (b) the company has capital equal to at least 20 percent of the value of the privatized company's assets. The new stock company has the option to purchase the privatized company at a price determined when the lease is signed, with those "lease" payments credited toward the purchase price. Approval of such management-employee buy-outs comes at the discretion of the Ministry of Ownership Transformation, which has approved approximately 1,000 at the end of 1994. Employees of former state-owned shops have equal bidding rights in privatization and were the successful bidder in about 40 percent of small company sales (see Marek Dabrowski, "'Citizen Ownership' versus 'Employee Ownership': The Polish Privatization Debate," *Journal of Employee Ownership Law and Finance*, National Center for Employee Ownership, Oakland, CA, Fall 1991; and Pawel Ruszkowski and Julian Pánków, "Experiences with Management-Employee Buyouts in Poland," Paper prepared for Fifth International Employee Ownership Conference, Merton College, Oxford, January 5-8, 1995).

South Korea:
Korea's privatization policy encourages widespread capital ownership by promoting the purchase of shares by low-income individuals and employees. Employees have a choice of two preferred forms of purchase: either a 30 percent discount on price or the ability to make installment payments for five years. In at least one privatization, employees received both a discount and preferential financing provided their shares were locked in until retirement. The typical post-privatization employee ownership component is approximately 10 percent.

Chile:
To gain worker support for privatization and to ensure broad-based share distribution, Chile's privatization architects devised a scheme known as "labor capitalism" that was offered as a "no lose" proposition for employees of companies to be privatized. As a general rule, workers were offered 5-10 percent of the company's shares at a discounted price. To pay for the shares, workers were allowed to borrow up to 50 percent of their severance pay, with the company promising to repurchase the shares at retirement at a value at least equal to the foregone severance payments. Thus, employees could buy shares at below market price with no cash outlay, with no risk of loss, and a potential for gain if the shares increased in value.

The resulting enthusiasm among workers led, in some cases, to workers becoming the largest single shareholder group via personal borrowings used to expand their stake. This was the case in the privatization of the Steel Company of the Pacific (CAP), Metropolitan Chilectra, LAN Chile (the Chilean airline), and the Chemical and Mining Society of Chile, among others. Another, broader-based example of labor capitalism occurred with the National Electricity Company (ENDESA), where shares were sold on credit to all public sector employees (including the armed forces), with payment secured solely by the shares.

Of the 15 enterprises that were fully privatized using labor capitalism, three became 100 percent employee owned while another three became 44, 33, and 31 percent employee owned. The remaining nine had an average 12 percent employee ownership (see Smith, op. cit.). Although these sales had normal rates of default, those defaults did not impact the enterprise and might have had a positive impact on savings, since many of the small investors put their money into financial assets for the first time (see Hachette and Luders, op. cit.).

Jamaica
Jamaica's privatization program includes a comprehensive set of incentives for employee ownership in both private and privatizable companies, with legislation providing for share grants, share discounts, and loans on favorable terms. Incentives are directed at ESOP participants, sponsor companies, and lenders.

ESOP participants are permitted a tax deferral on shares allocated to their ESOP accounts, a tax exemption on personal funds (salary deductions, bonuses, or retroactive pay increases) used to acquire shares, and a personal deduction for 25 percent of the principal and 100 percent of the interest for servicing a loan used to acquire shares. Dividends received on ESOP-held shares are exempt from tax. Shares held in an ESOP for more than six years are received tax free.

ESOP sponsors are given a number of incentives. (1) Where a company loans its funds to employees to acquire shares, the company can claim a tax deduction equal to one-third of the amount lent (50 percent where the board of directors includes at least one employee-elected director). (2) Where a company borrows funds from a lender and either (a) on-lends those funds to employees to buy shares, or (b) makes a grant to the ESOP to acquire shares, this expense is deductible to the extent of 100 percent of interest payments and 25 percent of principal payments (50 percent for compa-

nies with at least one employee-elected director). (3) Where a loan is made directly to an ESOP and the company is obliged to make grants to the ESOP to repay the loan (that is, a leveraged ESOP), the company can deduct 100 percent of that expense.

ESOP lenders are allowed an exemption on fifty percent of the interest earned on ESOP loans. This exemption increases to 100 percent for loans that result in an ESOP acquiring 15 percent or more of a company's shares. Banks are allowed a one percentage point reduction in the rate of corporate income tax (up to five percentage points) for each 3 percent of their total loan portfolio that consists of ESOP loans.

Even prior to enactment of this legislation (February 1994), Jamaican policy makers were encouraging employee ownership, including in the National Commercial Bank of Jamaica (NCB), which was 51 percent privatized. In the first phase of that privatization, 13 percent of the shares were reserved for employees via a "step approach" comprising four categories of employee preference shares: grant shares, matching shares (one-for-one), shares purchased at a discount, and shares purchased at full price. The overall first-round ceiling was 2070 shares. This 13 percent block of shares was held in a trust, with the purchase from the government financed with a loan from NCB repaid out of future employee earnings, either in cash or in installments (via the "Easy Payment Plan") over a 2-year period. Ninety-eight percent of eligible employees participated. Shares unsold after the first round were offered again to employees in a second round at less preferential rates and with a 50,000 share ceiling on individual purchases. Payment arrangements were similar to the first round. Employees' access to the shares depends on the payment terms. Grant shares are not tradable for two years, matching and discount shares are tradable only to other employees, via internal trading within the trust, and full-price "priority" shares are freely tradable.

Russia:

Employees of corporatized state-owned enterprises have three options in what is essentially a discretionary privatization program (see *Russian Privatization Program: A Guide for Foreign Investors*, State Committee of the Russian Federation for the Management of State Property, Moscow, August 1992). The first option includes a grant to employees of 25 percent of the company's authorized capital (provided no employee receives in excess of 20 times the minimum monthly salary). The shares offered are preferred, non-voting shares with a minimum dividend. In addition, employees have the right to purchase 10 percent of the company's voting shares at a 30 percent discount from book value with a 15 percent down payment and installment payments over 3 years. Payments can be made with cash, privatization vouchers, or company earnings. Vouchers can also be used for the down payment. Executive officers of the company are allowed to buy up to 5 percent of the voting common stock at book value and can use vouchers as payment (provided no executive buys stock in excess of 2,000 times the minimum monthly salary).

The second option permits employees to purchase up to 51 percent of the voting shares at 1.7 times the July 1992 book value of the company's assets. The cost in excess of book value reflects a control premium while pegging the value to mid-1992 reflects a favorable discount in a highly inflationary environment. As in the first option, company officers are allowed to acquire additional shares. A third, rarely chosen option allows managers and employees of certain medium-sized enterprises a one-year restructuring period, after which they can purchase 20 percent of the shares at book value plus another 20 percent on preferential terms.

In each of the three options, 10 percent of proceeds from the sale of shares to non-employees are contributed to the personal privatization accounts of employees and can be used to buy state assets undergoing privatization. In addition, employee groups can purchase non-corporatized firms at auction at a 30 percent discount with a 25 percent down payment and installment payments over 3 years. Upon the sale of assets of a liquidated or a non-corporatized company, employees receive up to 30 percent of the proceeds. Where an option to buy is included in a lease held by a workers' collective, the collective can purchase the leased assets.

In the early phase of Russian privatization, approximately 77.8 percent of corporatized firms were being privatized via option two (that is, majority employee ownership), with option one chosen in 21 percent of enterprises. Regardless of whether option one or option two is chosen, 91 percent of privatized firms are initially majority employee-owned. Managers often purchase additional shares in the voucher auctions and from workers. Workers' options and subsequent acquisitions together give managers and workers an average 70 percent of companies' shares, with approximately 17 percent owned by managers. Ownership of the remaining 30 percent is typically split between outside investors and the state property fund. In many companies, 10 percent of the amount held by the property fund will be transferred to the ESOP.

CHAPTER THREE
DESIGN ISSUES

Three core principles, generally enforced by legislation or regulation, lie at the heart of the concept of employee ownership: the **democratic principle** — a broad group of employees must be included in the plan; the **anti-monopoly principle** — the bulk of benefits must not be monopolized by a few participants; and the **private property principle** — participants must receive what is due them under the plan. These principles are generally embodied in the structure of the ESOP, which is typically set up in conjunction with an entity such as a trust, that is legally separate from the corporation (see Box 9). Fiduciaries administer the trust or other share holding mechanism. Fiduciaries have the power to acquire and hold shares, borrow funds, receive dividends, distribute shares, secure proper valuations and create a market for the shares, and in other ways represent and preserve the employee-shareholders' interests as trust beneficiaries. ESOP fiduciaries, therefore, are responsible for respecting the three principles above.

PLAN INITIATION

A threshold issue concerns the question of who initiates the ESOP. In the US, the UK, and Jamaica, legislation permits an ESOP to be initiated by any party, although the sponsor company's board of di-

Box 9. ESOP Share-Holding Mechanisms

The ESOP trust typically takes a 'spendthrift' form (that is, whereby the trust beneficiaries — employees — have no access to the shares until the conditions set forth in the trust's governing documents are met (e.g., passage of time, repayment of ESOP debt, retirement, etc.)). This arrangement results in two key benefits: (1) promoting long-term employee ownership by providing a lock-in mechanism ensuring that employees cannot readily liquidate their shares, and (2) ensuring deferral of taxes on the shares until received by the employees (a common practice for deferred compensation employee benefit plans). Without such a tax deferral mechanism, employees might be required to sell some of their shares to pay tax, undermining the rationale for encouraging employee ownership.

The sponsoring company, the employees, or both appoint the trust fiduciaries (trustees). Trustees might be corporate executives, worker representatives, or commercial trustees, such as bank trust departments. The latitude of trustee discretion can be either very broad or tightly conscribed via a directed trustee. The trustees typically act as the legal owners of the shares, with employees being beneficiaries of the trust. Thus, for securities law purposes, shares held in an ESOP are considered to be held by a single shareholder (the ESOP trust). Similarly, the trustees typically vote the shares, although that vote may be at the direction of the employee-beneficiaries.

Alternative share holding mechanisms are possible, particularly in legal environments without a trust tradition. For instance, Employee Shareholder Associations (ESAs) hold shares in Egypt with member employees retaining units in the ESAs. Shares can be held by a foundation, in an escrow account, via an employees' association, or a similar entity that enforces desirable lock-in or other restrictions. For instance, Tunisian law provides for an "intermediate repository," an escrow-like vehicle, that could be adapted to this purpose (see Jeffrey Gates, "Adapting Employee Stock Ownership Plans to Tunisia," USAID, 1994). In other institutional environments, a French-influenced portage (blockage) concept adapted to this purpose could utilize a separate account to hold shares for employees until the fulfillment of certain conditions (see Gates, 1993, "ESOPs and Privatization Promotion Funds - A Feasibility Study for Côte d'Ivoire, World Bank, 1993). Instead, a separate account could be established on the books of the company, although without an external ESOP mechanism, it is difficult for the company to address the full range of ESOP issues described in this paper. Internal ESOPs are best limited to companies with dominant employee ownership and with transfer restrictions that ensure continuation of that dominance (see David Ellerman, "The Internal Democratic ESOP," mimeo, Industrial Cooperative Association, Somerville, MA, 1989). Otherwise, shares could be held directly by employees, with appropriate transfer restrictions printed on the share certificates. Alternatively, those restrictions could be included in legislation, in the sponsor company's bylaws, or in agreements binding the employee-shareholders.

rectors must approve the plan. Initiation requirements vary and often are determined by the party that first expresses an interest in the ESOP concept. In Hungary, for example, where labor activists initiated that nation's ESOP program, ESOP legislation includes a lengthy, highly participatory 12-step process that must be followed to establish an ESOP.[29]

Some countries lack comprehensive ESOP legislation yet favor an employee ownership component in privatization and require that a minimum percentage of employees endorse a proposed plan (Poland, Russia). Other countries leave the initiation process undefined, issuing a general policy preference statement while allowing employees and/or managers to determine how to launch the plan (e.g., via a management/employee buy-out). For example, in Brazil, Côte d'Ivoire, Pakistan, and the Philippines, privatization policy includes a reference to employee ownership/ESOPs as a preferred component of privatization, even though the government provides no guidance regarding plan initiation and offers no specific encouragement.

Depending on the legal environment affecting labor/management relations, an ESOP's implementation can occur with or without the labor union's approval. A labor union or workers' council might initiate an ESOP, or employees could form a separate organization, such as an employees' association, to initiate the plan, as in Egypt and Guatemala.

An ESOP's initiation depends on both the political and commercial environment and the intended use of the ESOP. For example, where an ESOP is established by an unlisted company to buy shares from a major shareholder (for instance, where an ESOP is used primarily as a corporate financing technique) employees might participate in the ESOP trust as passive beneficiaries of the transaction. Such a situation differs markedly from a highly charged privatization context in which employees of an unprofitable parastatal are offered shares while being asked to reduce labor costs, change work rules, and accommodate a major restructuring to attract a controlling foreign investor. As with other issues in ESOP design, no one correct answer exists. Each design option has its advantages and drawbacks.

[29]Hungary's prescription for ESOP start-ups highlights the challenges associated not only with organizing employees but also with resolving the conflicts inherent in an effort that impacts diverse parties.

Box 10. Employee Ownership in the US Steel Industry

As of 1993, half the steelworkers in the US had negotiated six-year contracts, double the length of previous labor agreements in the industry. In the six major integrated steel companies, union members now appoint a representative to the board of directors and participate in joint committees with management at all levels of the company. They participate both in decisions affecting their area of work and in broader issues, including capital spending and planning. Pension benefits have generally risen and health care costs have been frozen, with the union, in certain cases, given a junior lien on some of the companies' fixed assets until funding for health benefits reaches an agreed-to level (see *Financial Times*, August 3, 1993). In return, steel workers have agreed to work more flexibly and to be trained in a wider range of skills. They will also receive up to $3,000 in bonuses, $1,000 of which will be linked to the profitability of the company (interview with Michael Yoffee, United Steelworkers of America, 1994).

Employee participation in some parts of the industry has gone even further. For example, in 1982, a joint labor-management team devised a 100 percent ESOP leveraged buy-out of Weirton Steel Corp., the West Virginia division of National Steel Inc., which has approximately 6,000 employees (represented by an independent steelworkers' union) and annual sales exceeding $1 billion. Although the company was 100 percent "employee-owned" after the buy-out and had three worker and three management representatives on a 13-member board of directors, the company was initially controlled by the seven board members representing the lenders who financed the buy-out. As the loan was repaid, the employee-shareholders gained the flexibility to elect a board more reflective of the company's ownership constituency. Conversely, when this employee-owned company later needed access to capital markets to raise funds for upgrading and modernizing its facilities, the company's capital structure was adjusted to ensure that outside investors could not gain control. This was accomplished by creating a second ESOP that held a new class of common shares with 10 times the votes of those shares sold to outside investors. Subsequent public offerings have since reduced the ESOP holding to less than 50% of the company's overall capital.

OWNERSHIP RIGHTS

In addition to their limited rights as trust beneficiaries, ESOP participation provides employees certain other rights of corporate ownership. ESOP design and supporting legislation or regulations must recognize that these rights belong to individual shareholders (or trustees)no matter what percentage of the corporation they own:

Liquidation rights ensure the shareholder's claim on corporate assets through a priority claim in the case of bankruptcy, and in some cases may provide a lien on company assets. For example, a recent U.S. Steelworkers' contract granted the union a junior lien on specific company assets to ensure the funding of health benefits (see Box 10). Although a lien on corporate assets does not by itself constitute employee ownership, liquidation rights are a key component of ownership.

Appreciation rights ensure the shareholder's ability to capture the appreciated value (as well as to risk the fluctuation in value) of a company's shares. An employee's investment in shares of his employer subjects the employee to the risk of non-diversification. Yet experience in developed countries suggests that ESOPs provide a promising mechanism for enabling employees to accumulate capital that they can later diversify. Diversification can be accomplished via a number of methods, with the sale of the shares being one possibility (see Transfer or Conversion Rights, below).

Income rights ensure the shareholder's ability to gain a capital-based source of income to supplement his/her labor income. Supporting laws might therefore encourage companies to pay dividends on ESOP-held shares by allowing sponsor companies to claim a tax deduction on those dividends (that is, in countries with a two-tier corporate tax system). Alternatively, companies might be allowed to deduct dividends on ESOP-held shares applied to service debt incurred to acquire those shares (as in Jamaica and the US). On the other hand, if a company is legally or contractually required to use all its discretionary cash to pay certain creditors — most notably senior commercial lenders in the case of a leveraged ESOP — employees might find that their ownership stake generates little or no income during the loan payment period. Balancing the various claims on a company's revenues remains one of the most challenging aspects of designing an employee ownership scheme.

Transfer or conversion rights entitle the shareholder to use the shares in any lawful manner, including selling, transferring, bequeathing, pledging as collateral, or converting the shares to cash. Employees generally regard freedom to sell or transfer shares as a key attraction of share ownership. Yet if shares are readily available to cash-strapped employees, experience suggests that they will soon be sold. Thus, where the policy goal is long-term share holding, ESOP design typically includes some form of lock-in for a certain period of time (see Design Alternatives, below).

In the case of a listed company with fully paid-up shares, the policy might be to allow employees to liquefy their shareholdings after a certain period of time. With an unlisted company, creating that liquidity presents a sensitive set of issues. For example, if sponsor companies are required to provide diversification for unlisted shares, they might need to repurchase those shares. This repurchase requirement, in turn, could present legal complications (e.g., in those jurisdictions where company or company-sponsored share purchases are forbidden). In addition, this requirement creates a share repurchase liability, which, if improperly managed, could jeopardize the value of all employees' shares.[30]

[30]Under US law, for example, ESOP sponsors are required to offer employees an opportunity to diversify 25 percent of their ESOP account balance when they reach age 55 and at least 10 years of participation, and 50 percent upon attainment of age 60 and 10 years of participation. Three investment options must be offered. Alternatively, the company may distribute cash in this amount. Jamaican law imposes an obligation on the sponsor to purchase up to 10 percent of each participant's shares at the end of each 3-year period and to apply those funds to diversify the account, provided that such diversification does not reduce the participant's account holdings below 50 percent invested in employer shares. Where the plan provides for an internal market (or where the ESOP shares are listed), Jamaican ESOP trustees are directed to seek a market in the shares prior to requiring that the sponsor repurchase the shares.

Voting rights are considered by many economists to be the most important component of ownership. In fact, much of the debate about modern corporate governance has focused on the relationship between ownership and voting control.[31] For example, in Russia, one of the key challenges facing privatizers is how to balance the political necessity of permitting substantial "insider" (that is, management/worker) ownership[32] with the economic necessity of limiting worker control of SOEs undergoing restructuring. As credit constraints tighten, it becomes important to avoid a situation in which insider-owners ally themselves with politicians who oppose privatization, thereby slowing the much-needed depoliticalization of these firms.[33]

Although corporate voting is important and highly sensitive, in the pragmatic world of corporate finance, policymakers might need to be flexible in structuring this component of employee ownership. US law, for example, limits the minimum voting rights required for ESOP participants in unregistered companies to seven major corporation transactions: mergers, consolidations, sales of substantial corporate assets, recapitalizations, reclassifications, liquidations, and dissolutions. In a developing country context, a privatized company with a leveraged ESOP[34] might need a substantial commitment of outside capital, in which case the capital provider might condition that commitment on having operating control. Depending on the flexibility of local company law (for example, if more than one class of shares is permissible), that control need not require that the financier own a majority of the ordinary shares, and the financier's control need not be in perpetuity.

Alternatively, in the case of an ESOP intended to diffuse economic power, this goal could be undercut if ESOP shares rest in the control of a group of insiders, particularly if these insiders paid a premium to obtain sufficient shares to achieve voting control. Such a situation could concentrate rather than dilute control. Yet voting rights, like other ownership components, can be designed to change over time.

Information rights. Ownership implies the right to a certain amount of information about a company. Securities laws typically require minimum disclosure before shares may be offered for sale, particularly in the case of sales to unsophisticated investors.

In developing countries with weak accounting and audit procedures and where securities laws do not adequately protect investors, employees might have insufficient information to properly assess an investment opportunity. On the other hand, where the shares are financed *for* employees rather than personally purchased *by* employees, the disclosure requirements might be less rigorous.[35]

Similarly, where policymakers hope to see employee ownership flourish in an environment dominated by tightly controlled or family-owned corporations, sensitivities regarding financial disclosure might require flexibility to ensure that a first step can be taken toward employee participation in ownership. On the other hand, this flexibility might need balancing against the need to adequately protect employees as minority shareholders. As a general rule of corporate law, majority shareholders and directors have a fiduciary duty, typically a duty of fairness, toward minority shareholders.

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[31]First chronicled by professors Adolph Berle and Gardiner Means in their classic book, *The Modern Corporation and Private Property*, 1932. Also see Jensen, op. cit.

[32]In October and December of 1993, Russian President Boris Yeltsin issued regulations that, among other things, mandated cumulative voting for corporate boards and prohibited employees from comprising more than one third of such boards. It is not clear whether compliance is widespread. See Kruse and Blasi, op. cit.

[33]See Maxim Boycko, Andrei Shleifer, and Robert Vishny, "Privatizing Russia," Brookings Institution, Washington DC, 1993.

[34]Where a leveraged ESOP acquires a block of shares that are paid for (and allocated to employees' ESOP accounts) over a period of years, the question arises whether those shares should be voted by employees, by managers, or by trustees. Where unallocated shares are voted by employees, should those shares be voted to mirror the vote on allocated shares, or should they reflect the vote of a majority of the allocated shares? Under US law, this issue is further influenced by regulatory guidelines requiring an ESOP trustee to make an independent judgment regarding the voting of unallocated shares to ensure that votes are cast in the long-term interest of the plan (which is considered to be permanent). The reasoning is that current plan participants might not be the ultimate beneficiaries where share allocations are spread over a period of years.

[35]For example, under US law, ESOP-financed shares are generally not considered to involve an investment decision by employees.

DESIGN ALTERNATIVES

Although ESOPs are typically custom designed, all designs must take into account these inherent rights of ownership, as well as the core democratic, anti-monopoly, and private property principles of ESOPs mentioned at the beginning of this chapter. Within that framework, a number of specific design issues need to be considered. Figure 5 provides an overview of the important points for consideration on the following ESOP design topics: Coverage and Eligibility to Participate; Required Level of Participation; Allocation of Benefits; Share Vesting; Benefit Limitations; Share Distribution; and Share Liquidity.

ESOP sponsor companies, if required to provide a market for their shares, will also need to project the magnitude and timing of this repurchase liability. As a general rule, factors impacting this liability include employee terminations, retirement, death, and disability, as well as (where required) funds to assist employees in diversifying their ESOP accounts. Other factors that can impact this liability include the ESOP loan repayment method, changes in share value, the age of employees, the proportion of stock and cash held by the plan, and the plan's distribution policy.

If poorly planned, repurchase liability can adversely impact a broad range of factors, including the company's appraisal, its solvency, its debt capacity, and employee morale. Methods for handling this liability include additional cash contributions, sinking funds, the use of retained earnings, employer borrowings, fostering trading among employees, and becoming a listed company (thereby providing employees an alternative to company-funded liquidity). Companies can also invest in corporate-owned life insurance policies on employees with large account balances.

FINANCIAL AND LEGAL ENVIRONMENT

An appropriate financial and legal environment can be crucial to the success of ESOPs. Their widespread application in developed countries (particularly the US) is primarily attributable to three factors:

- Government encouragement of their use as a highly flexible and adaptable technique of corporate finance;
- A receptive, market-oriented institutional environment, including well-established corporate and securities laws plus a range of sophisticated financial services; and
- The availability of professional support services, primarily legal, accounting, appraisal, banking, investment banking, and trustee services.

In many developing countries, however, capital markets are nonexistent, shallow, or rudimentary, with few disclosure requirements, weak accounting and financial standards, scant publicly available information, and a generally low level of monitoring and regulation. Injecting an employee ownership program into such an environment requires substantial care and a capacity to adapt the ESOP concept to less favorable circumstances. Although a preliminary analysis might show how an ESOP could be implemented on a demonstration basis, an analysis of the legal and financial environment is advisable in conjunction with any initiative that seeks to introduce ESOPs in a developing country on a more systematic basis. The analysis should consider the following questions:

- Is there a trust-like device available that could be adapted to hold the employees' shares?
- Does local corporate law permit a company to acquire its own shares? To borrow funds for that purpose on its own guarantee?
- Are companies allowed to impose restrictions on the trading of their shares?
- What disclosure is required where employees are buying shares?
- If fiscal incentives are being considered, is the tax system income based, transaction based, or some combination thereof?

Implementing ESOPs in the context of privatization need not await the ideal legal and regulatory environment. However, a receptive legal framework can expedite implementation and accelerate privatization. In formulating an ESOP initiative, it is advisable for policymakers to distinguish between short- and long-term objectives. If the short-term objective is to implement a pilot project, that often can be accomplished via an adaptation based on current law.

A more in-depth analysis must occur if the goal is to implement a more comprehensive ownership-broadening strategy, particularly if the purpose is to make ESOPs attractive not only to privatizable com-

FIGURE 5 — Overview of ESOP Design Issues and Alternatives

Coverage and Eligibility to Participate:

- Should all employees within a controlled group of companies be considered covered by the plan, or just those employed by the operating unit that sponsors the plan?
- Alternatively, should only those companies that share a minimum common ownership stake be included?
- Should only employees meeting minimum age and length-of-service requirements be eligible?
- If a minimum service requirement is permitted, should employment prior to adoption of the ESOP be taken into account?
- Should specific categories of employees be excludable (e.g., part time or seasonal)?
- Should employees who are also significant shareholders be eligible?

Required Level of Participation:

- Must all eligible employees participate in the plan?
- Alternatively, should it be permissible to cover a representative cross section of employees, provided that this participation does not discriminate in favor of highly paid employees?
- Alternatively, should there be a requirement that participation include a minimum percentage of eligible employ ees?
- Should participation be voluntary for each employee?
- What if an employer has unionized employees who have not yet bargained for this benefit?
- Should the ESOP be subject to collective bargaining?
- Should participation be extended to former employees?
- How should new employees be brought into the plan?

Allocation of Benefits:

- Should ESOP legislation or guidelines set parameters for how benefits can be apportioned among participants? For example, should it be permissible to allocate shares to employees in proportion to pay?
- If so, should there be a limit on the amount of pay that the plan may take into account, thereby limiting relative allocation disparities among employees to a specified range (such as 5:1 or 20:1)?
- Should allocations be made on a per capita basis (that is, equal)?
- Should allocations be based on a combination of pay and service? On the basis of hours worked?

In the absence of enforceable allocation limits, experience suggests that employee ownership schemes tend to concentrate shares in the hands of a few employees, typically senior managers.

Share Vesting:

- Once benefits are allocated to participants' individual ESOP accounts, should those benefits immediately be 100 percent vested (that is, nonforfeitable)?
- Should the ESOP be permitted to require that participants earn their ESOP-provided benefits over a period of time (that is, via a length-of-service requirement)?
- Should it be permissible to condition vesting on performance criteria, such as meeting productivity and profitability goals?
- In calculating vesting, should the ESOP be required to include employees' service prior to the plan's establish ment?
- Should otherwise vested accounts become forfeitable due to unacceptable or dishonest behavior (e.g. criminal conviction)?
- Should an employee's vested ESOP benefit be subject to the claims of creditors? Court orders? Contractual obligations involving spousal or child support?
- What should be the disposition of forfeited (that is, unvested) accounts? Should they be reallocated to remaining participants? For example, where shares vest at 20 percent per year and an employee terminates after three years of participation, what should be the disposition of the forfeited 40 percent of shares? Should they be held for allocation to new employees? To all employees?

The inclusion of a vesting concept in the ESOP design suggests a level of complexity and plan administrative capacity that should be carefully evaluated.

Benefit Limitations:

- Should an employer be permitted to offset an employee's ESOP benefits with other employer-provided benefits? With government-provided benefits?
- Should limitations be imposed on annual allocations to employees' ESOP accounts? If so, should those limita tions be based on a percentage of pay? Or should they be annual dollar limitations, or some combination?
- Should there be a percentage-of-the-company limitation (for instance, denying allocations once an employee's ESOP account exceeds a prescribed percentage of the company's overall share capital)?
- Should there be a limitation on the total percentage of ESOP-held shares creditable to the account of any one ESOP participant? A limitation on the yearly percentage?
- Should an ESOP be allowed to condition allocations on the company (or the employee and/or work group) attain ing certain goals such as meeting sales objectives or productivity benchmarks?
- Are rules needed to ensure that a plan does not become top heavy, with a few highly paid employees owning a disproportionately large percentage of shares?[36]

Share Distribution:

A threshold issue concerns whether there should be a lock-in requirement whereby shares cannot be accessed for a period of years.

- Should this restriction apply to all shares, or to the portion of shares for which full payment has not yet been made?
- Should the distribution of shares commence after a certain period of time after allocation, or after vesting?
- Should shares be locked in throughout the full period of employment and beyond (for example, until retirement age, death, or disability)?
- Should the ESOP provide that some portion of the shares are distributable while the employee is still working and some portion retained until retirement or termination?[37]
- Should there be tax incentives to encourage share lock-in?[38]
- If an ESOP loan is involved, (that is, if borrowed funds were used to acquire shares), should distributions be delayed until the loan is repaid?[39]

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[36]For example, Jamaica's ESOP law includes an interrelated set of limitations: (a) allocations among participants may not discriminate other than on the grounds of salary and/or length of service; (b) plans may not become top heavy (that is, no more than 70 percent of ESOP assets may be allocated to the most highly compensated 30 percent of participants); (c) in any one year, no participant may be allocated less than 10 percent of the number of ESOP shares allocated to any other participant; and (d) no participant may accumulate more than 10 percent of the total number of ESOP shares. Also, additional allocations are disallowed once an employee acquires 5 percent of the company's share capital.

[37]For example, under US ESOP law, a participant entitled to a distribution has a right to demand the distribution in shares, with the exception that cash distributions are permitted if the sponsor company's charter or bylaws restrict ownership of substantially all of the employer's shares to employees or to an ESOP trust. Distributions generally must begin no later than one year after the end of the plan year in which an employee retires, becomes disabled or dies, or five years following a separation from service (unless reemployed). Spousal consent might be required. Where an employer is required to repurchase distributed shares (that is, where the shares are not readily tradable or are subject to a trading limitation), a participant receiving a total distribution may be paid the repurchase price over a 5-year period beginning 30 days after the exercise of a required put option (provided adequate security is provided and reasonable interest is paid). If the distribution of shares is made in installments, the employer must pay the repurchase price for each installment no later than 30 days after the exercise of each put option. An ESOP may assume an employer's obligations under a put option but cannot be required to do so. A US ESOP may not enter into a legally enforceable buy-sell agreement. Under Jamaican ESOP law, an employee's put option right matures during continued employment and applies to 10 percent of the participant's shares at the end of each 3-year period, provided the option is not exercised during employment with regard to more than 50 percent of allocated shares.

[38]In Jamaica, ESOP legislation prohibits employee access to ESOP-held shares for two years. Shares distributed in year three are taxed on 100 percent of their value, with a 25 percent reduction in the amount subject to tax over each of the succeeding four years. Thus shares distributed after six years are received free of tax.

[39]An ESOP may involve a dual expense: both an employer expense of contributions for funding the ESOP, and a follow-on expense of repurchasing those shares from employees. Thus, care is advised to ensure that these claims do not unduly burden the sponsoring corporation. For example, US ESOP law provides that the ESOP distribution requirements do not apply to that portion of a participant's account balance consisting of employer securities acquired with an ESOP loan until the end of the plan year in which the entire loan is repaid.

- Should a portion of the shares be distributed periodically as the loan is paid?[40]
- Should a distinction be made in the lock-in requirements depending on whether the shares are acquired with employer or employee funds?
- Should the terms of the lock-in be based on whether the shares are acquired by employees on concessional terms (a common feature of employee ownership in privatization)?

Share Liquidity:

At some point, employees will want to convert their shares to cash. Depending on the lock-in period, employees could access cash in a very short time (for instance, two years after allocation in Jamaica's ESOP scheme) or not until termination of employment (as in the US). Questions surrounding this fundamental issue include:

- If distribution must wait until an ESOP loan is fully repaid, should there be a limit on the term of the loan?
- If ESOP allocations are to be based on loan principal payments, should there be rules governing permissible methods of amortization (for example, to preclude the back-end loading of principal payments)?
- Should an ESOP participant be allowed to sell shares in order to diversify?
- Should an ESOP sponsor be required to provide a market for shares if there is no active market in the shares (that is, should employees have a put option enforceable against the employer)?
- Would such a requirement create an unacceptable liability for the company?
- Should such a put option be enforceable only within a specified period?[41]
- Should deferred payment terms be permitted under the put option? If so, over what period of time?
- Should an employer be required to maintain a "sinking fund" to provide liquidity for shares distributed from an ESOP for which there is no ready market? If so, what amount should be set aside each year, and what fiscal relief, if any, should be available for this purpose?[42]
- Should ESOP-sponsoring companies be encouraged to develop an internal market of active trading among em ployees?[43]
- Should non-employees be permitted to participate in this market? Former employees?
- Should trading in ESOP shares be limited to this market? Limited to designated days?
- Should a company be permitted to prioritize such transactions by category of purchaser and seller (e.g., beneficia ries of deceased employees, those in financial distress, etc.)?
- Should an employer have a right of first refusal before an employee is allowed to sell ESOP-distributed shares to others?
- Should such a requirement be limited to shares for which there is no readily available market?
- What should be the duration of the sponsor company's right of first refusal?[44]

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[40]Limitations on transferability need to be carefully structured lest they have perverse results. For example, Russia's State Property Agency (GKI) issued a decree forbidding shareholder agreements on the transferability of shares. The apparent intent was to preclude management entrenchment (e.g., by managers and employees agreeing not to tender their shares to an interested foreign investor). Nevertheless, because managers and employees cannot agree among themselves to retain the company in a dominantly management/employee-owned structure, cash-strapped employees are routinely selling their shares to managers. Thus, the impact of the restriction is to foster dominantly management-owned companies with entrenched manager owners. Such management buy-outs (whether immediate or deferred) are also now prevalent in Mongolia and Poland (largely via management-led purchases of companies being liquidated).

[41]Under US law, employees receiving shares of a company that are not readily tradable are allowed two 60-day put option periods spread over a 15-month period, thereby allowing them the benefit of selling their shares shortly after receipt or later, following a subsequent annual appraisal.

[42]For example, Jamaica provides a sponsor company tax deduction both for the purchase of ESOP shares and for their subsequent repurchase from employees, provided repurchased shares are contributed to the ESOP.

[43]Internal markets are used to varying degrees among companies with employee ownership schemes. Jamaican ESOP law provides for the creation of a company-facilitated market in ESOP shares. One of the most sophisticated internal markets in a developed country has been established by San Diego-headquartered Science Applications International Corporation (SAIC), a US firm 90 percent owned by its active 20,000 employees. Shares are traded quarterly at a value based on a formula approved by an outside auditor, with buy-sell orders matched by a company-sponsored broker/dealer. The company's various employee share schemes may (but are not required to) participate in the market to balance the supply or demand for shares based on employees' buy/sell orders.

[44]For instance, US law permits ESOP-sponsoring companies to impose a right of first refusal not exceeding 14 days on shares distributed from an ESOP where those shares are not publicly traded. The right may be in favor of the sponsor, the ESOP, or both.

panies but also to companies presently operating in the private sector. Such an analysis should be wide ranging and include not only an economic evaluation but also an appraisal of financial feasibility, legal adaptability, political support, investment availability, and social and cultural receptivity.

Financial analysis: Examine the economic environment, identifying possible sources of credit, assessing the liquidity potential within various sectors, and evaluating the capacity of the commercial environment (financial, technical, etc.) to support ESOP-like financing techniques.

Legal evaluation: Review the commercial legal environment in order to identify adaptable legal forms and to note any changes (to local law and/or to the ESOP concept) required to make ESOPs readily acceptable. An understanding of local corporate law is essential when crafting an ESOP initiative.

Political environment: For example, if the goal is to include employees in privatizations, evaluate whether employees are represented by a union and whether the union opposes privatization. It is also useful to determine the political priority given to the ESOP (and to expanded ownership), and whether the government is willing to forego privatization (or tax) revenue, or to accept payment for shares on a deferred basis.

Investment Availability: Determine whether the government is willing to do what is required to make the employee ownership component acceptable to investors. Consider whether the government is willing to make ESOPs attractive to privately-held companies, and whether, for example, company-targeted incentives are fiscally and politically feasible within the constraints of structural adjustment agreements.

Social and cultural acceptability: Although more difficult to assess, these issues are also important, including whether there is a history of employee ownership or any experience with cooperatives. This evaluation should also consider whether the country has a climate of tax avoidance or other problems that might undermine the ESOP initiative. Policy makers may find it advisable to encourage a range of employee ownership initiatives, including initiatives that enable companies to make individual share awards for superior performance.[45]

[45]See "Using Equity-Based Compensation as an Effective Business Strategy," Foundation for Enterprise Development, Washington, DC, 1993.

ACCOUNTING

Accounting laws require attention to ensure that ESOP-related transactions do not have unintended effects. For example:

- Is leveraged ESOP debt regarded as off-balance sheet debt or as a balance sheet liability?
- Is there a corresponding reduction in equity, with the liability reduced (and equity increased) as the ESOP loan is repaid?
- Are all ESOP shares treated as outstanding for earnings per share computations?
- Are employer ESOP contributions charged as compensation expense?
- Is interest on ESOP debt charged to expense on an accrual basis?
- Are ESOP dividends charged to retained earnings? When used to repay ESOP debt? When paid out to participants?

MATURING ESOPS

The maturing of an ESOP brings with it certain challenges that are best addressed during the design phase. For example, an ESOP in an unlisted company may be required to operate similarly to listed companies, including adhering to certain governance procedures, devising proxy solicitation mechanisms, and seeking and electing nominees to be directors.

In a difficult business environment, an ESOP can result in certain complications. For example, declining share values might coincide with a need to make distributions to those employees terminated during an economic downturn. If the company is required to repurchase those shares, this repurchase liability could worsen the company's financial difficulties, creating additional cash demands that could further depress share values.

ESOP financing accentuates these challenges. Leveraged ESOPs, for instance, enable employees to acquire a block of shares at current values. If those shares increase dramatically in value, the share repurchase liability for unlisted companies also increases dramatically, requiring progressively greater attention to cash flow planning.

The design issues outlined in this chapter suggest the need to carefully project the short- and long-term costs and benefits of ESOPs, and illustrates how implementation of the ESOP plan can impact the company and its employees. Although unforeseen events can wreak havoc on even the best-planned ESOP, proper design can anticipate most eventualities and lessen any possible negative impact.

Within the framework of the ESOP's three operational principles, plan initiators can proceed to answer the numerous specific design questions that give each ESOP its own unique character: plan coverage and eligibility to participate, required level of participation, allocation of benefits, benefit limitations, share distribution, and share liquidity. Accounting methods, plus operational rules and procedures, if laid out properly at the outset, provide an important base from which to operate an ESOP that will successfully fulfill its goals.

ESOP viability depends upon a host of institutional and environmental factors. Government support, receptive financial markets, and the availability of a range of professional support services can lead to increased ESOP utilization, but ESOPs can and do exist without them. In situations where ESOP use can expedite privatization, it may be advisable to proceed expeditiously, even without an ideal climate.

For ESOPs to meet specific, focused objectives, it is best if in-depth analysis is conducted of not only the economic environment but also of the financial, legal, political, foreign investment, social and cultural environments. Special thought given to accounting rules as well as to local laws and customs and to the demands of ESOPs as they mature will lead to sound designs that do not result in unintended consequences. Of course, even the most thoughtfully and thoroughly designed ESOPs cannot succeed unless the sponsor company is properly managed. Alternative methods of operating an ESOP are discussed in the next chapter. ■

CHAPTER FOUR
OPERATIONAL ISSUES

One of the key challenges associated with ESOPs lies in ensuring that employee ownership does not interfere with efficient and effective company operations. Thus a key step in ESOP decision-making involves an evaluation of operational issues. Achieving an appropriate balance between shareholder rights and responsibilities provides a central ESOP challenge.

CORPORATE GOVERNANCE

The presence of an ESOP does not imply that any one class of shareholders has the right or the competence to manage a company. The appropriate governance structure for an ESOP company, like the structure of the ESOP itself, will vary according to specific company and country circumstances. The policy environment in which an ESOP company operates can also play a key role in determining the most suitable structure.

A major issue concerns whether policymakers should influence or prescribe the composition of the board of directors. Jamaica, for example, encourages ESOP companies to have employee representation on the board of directors. Others, such as Germany (see Box 11), encourage or require employee participation in a supervisory board or in a works council with specified co-decision making rights with management on a range of workplace issues. The German co-determination model provides the model for labor practice "harmonization" policies in the European Union.

It should be noted that the ESOP concept differs significantly from the unique, and widely unsuccessful, Yugoslavian worker self-management model, and from the particular political and social environment in which it existed. The Yugoslavian model included three primary characteristics that, in combination, ensured its failure. First, the company's earnings were uniformly directed to a wide range of non-recoupable uses, known as "social capital," leaving employees without clearly defined property rights. For example, earnings could be dedicated to uses not related to operations, such as to pay for vacation hotels. Secondly, profit-making firms routinely faced uncertain tax rates levied to support loss-making companies, with a predictably negative impact on morale and profit motive. Third, the government's soft budget constraints ensured easy access to capital even for poorly performing-enterprises.[46]

A key challenge with governance in companies with employee ownership lies in striking the proper balance between employees' interests, such as increased wages, and the needs of the company as a going concern, such as undertaking new investments. The historic role of the workers' councils in Yugoslavia and Poland, in particular, presents a challenge to corporate governance in a market setting. On the other hand, such councils also provide an established channel through which to implement an employee-owner education program.[47]

Proper corporate governance forms one of the three crucial elements necessary for a company to operate successfully in a competitive market environment. The other two elements are product competition and the ability to compete for funding in fully functioning capital markets. Economies in the throes of shifting from state-directed to market-driven envi-

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[46]See Milan Vodopivec, *The Effects of Democratic Determination of Wages - Theory and Evidence from Self-Managed Firms*, World Bank, Washington DC, 1992; and "Determination of Earnings in Yugoslav Firms: Can It Be Squared with Labor Management," in *Economic Development and Cultural Changes*, University of Chicago, 1993.

[47]It has been suggested that, in certain circumstances (such as Poland), the inclusion of employees in privatization recognizes and legalizes de facto property rights. Voucher privatization strategies, by contrast, are seen as a means for canceling de facto property rights and returning ownership back to the government, which, in turn, is expected to give these rights to citizens even though it may be against the bureaucrats' self interest to do so. See Smith, op. cit.

Box 11. Co-determination Systems in Germany and the UK

In Germany, large companies have an "enterprise co-determination" system, regardless of whether employees own company shares. Under this system, the managing board of directors, which has daily management responsibilities, is overseen by a supervisory board, a high percentage of whom are employee representatives. For companies with more than 2,000 employees, the law requires that half the members of the supervisory board represent the firm's employees; two-thirds must be employees and one-third external trade union representatives. For firms with 500-2,000 employees, one-third of the supervisory board members must represent the employees. No managers are permitted on the supervisory board, although a representative of the company's primary lender ("hausbank") commonly acts as the supervisory board chairman.

Smaller companies have a "workplace co-determination" system, where workers in any company employing 5 or more may request that a works council be formed to resolve workplace issues jointly with management, including employment and training policies and the day-to-day organization of work. Foreign companies operating in Germany are expected to comply with these co-determination system requirements.

German corporations are unique in that their stated goal, rather than the maximizing of return on investment, is instead the satisfaction of the goals of shareholders, employees, customers, suppliers, and the general public (that is, both shareholders and stakeholders). A primary objective of the company is to operate in perpetuity (see Michael Porter, *Capital Choices - Changing the Way America Invests in Industry*, US Council on Competitiveness, Washington DC, 1992). Co-determination legislation is also in operation in Austria, Denmark, Luxembourg, Netherlands and Sweden. Most members of the European Union mandate workplace co-determination, although not enterprise co-determination.

In the UK, while not mandatory, a co-determination system was implemented in 1990 as part of the 100 percent employee buy-out of Chesterfield Transport Ltd., a municipal bus company formerly owned by the Chesterfield Borough Council. At the outset, 85 percent of the ordinary shares were held collectively by an Employee Benefit Trust (EBT), which transfers shares to individual employee accounts in a profit-sharing scheme (also organized as a trust) as the loan is repaid. The plan allows the EBT to own a majority of the ordinary shares in perpetuity via an "ECOP" ("employee common ownership plan").

The EBT's seven directors includes one from each of the three sections of the workforce, three external experienced business professionals, and one managing director. Once the EBT's initial loan is repaid, provision was made for a fourth employee-elected trustee to replace one of the outside trustees. The company's board of directors comprises three executive directors and one employee director. Also, the company established a Joint Trade Union/Management Committee with duties similar to those of a supervisory board in the German co-determination model. The trade unions continue to negotiate with the company regarding terms and conditions of employment, grievance and disciplinary matters, health and safety, etc. All union agreements are contained in the company's articles of association, in the rules governing employee share schemes, and in the EBT's founding documents.

ronments will force newly privatized firms to experience the pressure to produce quality products and secure commercial funding. This competitive environment will, over time, tend to push firms towards effective forms of corporate governance. The starting position is, nonetheless, important, especially with regard to restructuring.[48]

Policy environments also play a key role in the success or failure of a country's enterprises in a free market setting. For example, for enterprises still under state control, hard budget constraints must exist to ensure that a company's management is denied access to government credit to fund activities that reflect poor management practices.

VALUATION

Unless a company has an active, listed market in its shares, it is advisable to devise a methodology for ensuring a fair valuation of employees' shares on a periodic basis. Alternatively, share values can be set via trading among employees. A detailed exposition on valuation methodologies is beyond the scope of this introductory paper.[49] International practice, however, typically takes into account certain factors in formulating an enterprise appraisal. These factors include:

- Nature of the business and the history of the enterprise;
- General economic outlook;
- Conditions and outlook of industry;
- Book value of shares and the financial condition of the company;
- Earning capacity;
- Goodwill and other intangibles;
- Other sales of shares;
- Size of the block to be valued; and
- Market price of shares of comparable companies.

In valuing shares for ESOP purposes, it is generally advisable to use a qualified independent appraiser and to base the valuation not on a formula but on an in-depth examination of the company as a going concern. Where ESOPs are granted fiscal relief, tax authorities generally demand that an independent professional with relevant experience periodically conduct a company's valuation.

LABOR UNIONS AND EMPLOYEE OWNERSHIP

Historically, labor unions have resisted the idea of members owning shares in companies for which they work, partly out of a fear they will be "co-opted" and partly due to concerns about how to conduct labor negotiations when workers are also owners ("bargaining with ourselves"). Recent experience in the US suggests that ESOPs conceived by and adapted to the needs of unions can play a positive role in transforming traditional adversarial labor-management relationships. The US Steelworkers Union, which embraced ESOPs as part of a job and pension preservation strategy during the 1980s (see Box 12), illustrates this point.

Other US unions also have become active in the employee ownership area, particularly in the deregulated transportation sector. The Airline Pilots Association took a leading role in negotiating substantial ESOP stakes in several major carriers, including United Airlines, TWA, and Northwest Airlines. In the ground transport sector, several major trucking companies negotiated stock-for-wage concessions with Teamster Union members. Although many of these cost-cutting measures temporarily preserved company operations — and jobs — several firms nevertheless failed in this newly competitive environment.

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[48]This governance ("agency") dilemma is a key factor pushing privatization policymakers to recommend various privatization strategies designed to foster the emergence of a "core investor" capable of making the difficult decisions necessary to restructure state-owned enterprises. See Jensen, op. cit. These strategies have typically taken the form either of the sale of (a) controlling interests to a strategic investor or (b) voucher privatization designed to result in a significant amount of shares being under the control of a small group (such as a mutual fund manager in the case of the Czech Republic's voucher program). It should be noted that the design of the Czech voucher program served the objectives of speed and equity more than those of corporate governance. See Nemat Shafik, "Making a Market - Mass Privatization in the Czech and Slovak Republics," World Bank, Washington DC, 1993. See also Ellerman, "Privatization in Post-Socialist Economies," Human Systems Management, v. 12, no. 4, 1993, regarding the distinction between a "control packet" of shares and a "restructuring block" of shares.

[49]See ESOP Association, *Valuing ESOP Shares*, Washington DC, 1990; and G. Bennet Stewart III, *The Quest for Value - A Guide for Senior Managers*, Harper Business, 1991.

Box 12. Labor-Management Relations in the US Steel Industry

One of the oldest and most militant of industrial unions in the U.S., the United Steelworkers of America, faced the dilemma of protecting an aging membership at a time when domestic steel markets were progressively opening to lower-cost foreign imports and being subjected to new labor-saving mini-mills and continuous casting. Confronted with the reality of needing to draw less money out of their employer companies in order to ensure their ongoing viability, the Steelworkers bargained for an ESOP stake in those companies (see Box 14).

The union's ESOP strategy further altered the dynamics of collective bargaining as employees realized that the money they had formerly regarded as "lost" in negotiations (that is, pay and benefits) was being invested in the company or used to finance their acquisition of shares. This "foregone" money was instead helping secure their jobs (and pensions) while simultaneously allowing them to accumulate an asset whose value their efforts could impact.

This ESOP strategy also confronted union leadership for the first time with corporate governance issues. The union found itself with the unique task of representing its members both as workers in pursuit of fair wages, safe working conditions, and the like, and as owners demanding sound corporate policies to ensure acceptable returns.

Yet the union's dual role served its agenda well. Ownership provided union officials with better tools and information with which to shape their long-term job and pension preservation strategy. Typically the union bargained for preferred shares, forfeiting some potential share appreciation in return for a priority claim on company earnings to help offset some of the direct compensation swapped in exchange for their ESOP stake. As a general rule, the Steelworkers insisted upon the inclusion of three features in their contracts: (1) that ESOPs be kept separate from pensions, (2) that unlisted shares be valued independently, and (3) that employees vote their shares.

As a result of the ESOPs, union leaders reported a change not only in workplace rules and expectations but also in relationships within the workplace as workers began to be treated as shareholders. In the case of majority employee-owned companies, workers and union leaders also found it advisable to coalesce around strong, experienced managers and to support them as long as they performed.

One of the more transformative aspects of this strategy affected labor union leadership. Employee-owner union members began to expect and insist upon leaders with greater financial sophistication and commercial orientation, and with the ability to understand how to preserve jobs in an increasingly global marketplace. The rhetoric of the class struggle gave way to the need for financial literacy and operational flexibility. As more mechanisms were designed and implemented to enhance interaction between workers and managers, negotiations became more ongoing and incremental and less periodic and dramatic, while strikes became a last rather than a first resort.

As the Steelworkers continue to refine this ownership strategy, they steadily devise new ways to reflect their members' concerns. Recently they negotiated several contracts that include a "right of first refusal" whereby an employer company must first be offered to employees via an ESOP before it can be sold to others. With support from the government's Federal Mediation and Conciliation Service, the Steelworkers Union in October, 1994 established a "Worker-Ownership Institute" designed to provide training and information, particularly in the areas of problem solving and financial understanding related to employee ownership.

EDUCATION AND TRAINING

Successful implementation of an ESOP initiative suggests an intensive and sustained employee education and training program, along with an ongoing communication initiative. Employee communication should be distinguished from disclosure, which involves mandated minimum reporting and information sharing. An employee education program should include concepts such as:

- Shares as an alternative to bank deposits;
- The difference between interest and dividends;
- The impact of retained earnings;
- The impact of inflation;
- The difference between an investment with a predetermined value and one whose value could change based on supply and demand; and
- ESOP-type ownership participation vs. unrestricted (and non-concessionary) ownership.

An ongoing "financial literacy" program is generally advisable, although it may need to recognize certain potential sensitivities to financial disclosure, particularly in companies with a long history of closed family ownership or with confrontational labor relations. Ideally, an employee-owner education program ensures that all employees can read and comprehend the company's balance sheet and its profit and loss statement. In addition, education programs directed at managers of ESOP companies help them understand how to (a) manage a company in which employees own shares, and (b) share financial information with employees. Furthermore, it is advisable to assist union leaders in understanding how to (a) attract fresh investment capital, and (b) cope with a membership comprised of worker-owners.

SPECIAL CONCERNS OF DEVELOPING COUNTRIES

Adapting ESOPs for use in developing countries presents numerous challenges, many of which are addressed in other sections of this paper. This section summarizes several of these major challenges.

In the financial and institutional environment of developing countries, employees typically have few discretionary funds, modest savings, and low earning power. In addition, the financial community often lacks resources and is reluctant to expand limited resources to support ownership-transfer transactions (versus financing new or replacement capital). This problem arises particularly where the creditworthiness of companies (including privatizable firms) is questionable, where substantial restructuring is needed, or where the impact of employee ownership is new or unknown.

Similarly, the government might be constrained in its ability to provide financial support for ESOPs, particularly where structural adjustment agreements hamper its discretion to assume additional debt (such as accepting a note or installment payments) or to provide ESOP-targeted fiscal incentives that could jeopardize current tax revenues. The need to finance a social safety net, including those costs related to privatization restructuring, might further constrain policymakers' ability to offer concessions to encourage employee ownership. In such environments, it might be difficult for a government to encourage capital accumulation on the part of those who already have relatively good jobs and steady incomes.

More fundamentally, it takes time to develop fully functioning institutions and regulations, particularly in economies with little experience with share ownership and with weak capital markets. Introducing the concept of property rights (or a new property concept) can prove challenging, particularly where the institutions that make a market possible are not yet in place . At a minimum, the government must begin to instill a system of secure and transferable property, enforceable contracts, and reliable currency. Once accomplished, these fundamentals create the rudimentary basis for capital market development.

Any development policy designed to impact property rights has the potential to create social tensions and insecurity. Note that replacing traditional systems of property rights, including communal property rights, might be difficult, even, for example, where corporatized employee-owned groupings of farmland would yield economies of scale not achievable under the original system. The prevalence of informal property rights with incomplete titling procedures present a further, yet surmountable, obstacle.[50]

Lack of reliable company information poses a risk to potential employee-investors. Traditional closed

[50]Note "The Proform Solution," a newly efficient land titling and registration procedure introduced in 1994 by the Path to Property Association (Zurich).

family companies tend to impede the adoption of an ESOP as well as the flow of information. Commonly, without fully operational accounting or audit systems, available information is of limited or poor quality. For reasons such as these, local corporate, labor, and tax laws may need amending to accommodate ESOPs. Notions of fiduciary obligation where new or only partially developed, require attention to ensure proper adaptation for indirect forms of employee ownership.

For companies needing capital, introducing employee ownership might result in little new capital while potentially constraining — or giving the appearance of constraining — investors desiring to implement needed changes. Employee ownership can either enhance or detract from a firm's attractiveness to foreign investors, depending on such factors as the recent history of labor relations in the company and the overall political and economic environment.

For companies seeking conversion to either total or majority employee ownership, the retraining of employees and managers becomes an issue. Highly capital-intensive firms, such as telecommunications or power generation, may find significant employee ownership either impractical or inequitable. If so, other forms of participation such as profit sharing, gain-sharing, and co-determination, can complement or substitute for ownership participation.

Share price volatility, particularly in companies heavily impacted by world commodity prices, raises issues of employee understanding and satisfaction, share liquidity, and company liability. Employees in such companies or in economies with a colonial heritage might greet with skepticism any proposal to make them co-owners, particularly if exclusion from ownership has long been a fact of life.

A lack of professional competence might hinder design, implementation, and administration, particularly in key service areas such as law, accounting, appraisal, and investment banking. Providing necessary governmental oversight can put an additional strain on public administration systems lacking sufficient staffing, motivation, funding, or competence.

In view of the special circumstances noted above, establishing ESOPs in developing countries may prove challenging. Governments that consider promoting ESOPs as a policy objective must act as catalysts, taking into account a wide range of concerns, including not only the external, institutional environment impacting the firm but also the internal aspects of affected companies. ■

CONCLUSION

All in all, a strong yet resilient ESOP results from a design based on a thorough analysis of objectives, a creative application of the alternative design and financing methods available, and careful consideration of the operational framework put in place to support the changing needs of an ESOP. The introduction of employee ownership and ESOPs presents both political and practical challenges. Experience suggests that no single model will suffice for all situations and that no one correct method of implementation exists. Proper adaptation of the ESOP requires an analysis of each country's legal, economic, and social circumstances, and a willingness to design a strategy appropriate to each corporate entity's immediate environment.

As this paper illustrates, no two ESOPs are identical. Some may be little more than profit-sharing arrangements implemented in conjunction with a management buy-out. Others include an element of permanent majority employee ownership and control. Some provide free shares, others offer discount purchases, while others provide that shares be purchased solely with the sponsor company's future earnings. While some ESOPs distribute shares to employees upon purchase, others retain the shares for distribution when employees retire. These variations suggest enormous latitude, both for setting public policy goals and for creativity within ESOP sponsoring companies.

The primary strength of the ESOP concept lies in its flexibility in achieving numerous goals while broadening corporate ownership. Originally envisioned and designed as an ownership-broadening technique of corporate finance, the concept continues to evolve and to attract the interest of policymakers worldwide. While certain key principles help guide the process, experience suggests that the final details of each ESOP — and each ESOP initiative — need to be custom designed to fit specific economic, political, social, cultural, and commercial circumstances. ■

Annex - Employee Ownership in Privatization in the Former Soviet Union

COUNTRY	PREFERENCES GIVEN TO EMPLOYEES
Armenia	1. Labor collectives awarded up to 50 percent discount. 2. Installment payments available for individual workers.
Azerbaijan	1. Labor collectives permitted free use of certain objects of industrial and social value. 2. Sale of shares and other assets on an installment basis, with concessions worth up to 30 percent of the value (plus an additional 10 percent if some post-sale conditions are met), with certain net profits used for financing.
Belarus	Implicit preference for worker buy-outs.
Estonia	1. Workers as preferred buyers in the first phase of small-scale enterprise asset dispositions (but reduced preference in later auctions). 2. No price concessions in the sale of shares of corporatized SOEs.
Georgia	1. Shares sold to employees at a discount not exceeding 20 percent of par value within two years of the registration of a corporatized SOE (lock-in during this period). 2. An association representing a majority of the workforce is eligible to participate in auction or competitive bidding to buy the enterprise on a two-year installment basis (the first payment must be at least 50 percent of the total price).
Kazakhstan	1. Under the current program, partnerships comprising more than 50 percent of employees are entitled to 10 percent discount in auction or tender of small-scale enterprises. 2. For medium to large corporatized SOEs, the labor collective is entitled to receive, free of charge, 10 percent of the total authorized capital, subject to individual salary caps.
Kyrghyzstan	1. Under the suspended program, the labor collective (not individual members) has the right to buy 20 percent of the shares of its enterprise at a 30 percent discount, in installment payments, plus free transfer of certain social infrastructure facilities. 2. Under the Concept Note on Privatization, the labor collective is given an option to choose among three different modes of share allocation, ranging from 20 percent to 51 percent owner ship interest, with preferential terms limited to the use of privatization vouchers (up to 25 percent) plus other privileges (up to 10 percent).
Latvia	Discounts available to workers for disposition of assets.
Lithuania	Employees eligible to buy up to 50 percent of the total authorized capital of large SOEs (but only 30 percent may be voting shares) at preferential rates prior to the public subscription of shares.
Moldova	1. Up to 20 percent of the shares of an enterprise sold to employees at a nominal value (likely to be much lower than the book value under the unique capitalization plan announced for mass privatization). 2. Labor collective's buy-out offer preferred to those comparable from outside buyers.
Russia	1. A menu of options given to employees of a corporatized SOE: (a) receipt, *gratis,* of 25 percent of non-voting shares, subject to individual salary caps, plus a right to purchase 10 percent of voting shares at a 30 percent discount under a three-year installment plan (while managers may buy up to 5 percent at book value); (b) purchase of 51 percent of the authorized capital at 170 percent of book value); or (c) a work-out contract for one year for a right to purchase 20 percent of shares on favorable terms (applicable only to certain medium-sized SOEs). 2. 30 percent discount and one-year installment plan for employee buyers in privatizations of non-corporatized enterprises through competition or at auction.

Tajikistan	Active participation by labor collectives, which have first priority in selecting among the possible modes of ownership transfer (ranging from leasing to outright sale).
Turkmenistan	The draft Privatization Program contemplates that for small retail units, shops with less than five workers will be given free to employees, and that the next class of small shops can be purchased by employees at a residual value. For larger shops and corporatized medium to large SOEs, employees will be eligible for up to 25 percent of the total number of shares at a discount, with the rest divided among managers (5 percent), suppliers (10 percent), and the state (60 percent).
Ukraine	1. Under the current lease law, the labor collective as the lessee has the right to income earned and a three-year period to decide on a buy-out while other potential buyers are excluded (this is likely to change in the future). 2. Buyers' association formed by not less than 50 percent of the workers given certain discounts to buy all or a part of their small-scale enterprise (at auctions, this association to be preferred, if all terms are equal). 3. For large, corporatized SOEs, employees permitted to use their privatization certificates to buy shares at nominal value and to use cash (up to half of the value of their certificates) to buy additional stock at nominal value.
Uzbekistan	1. Worker buy-outs financed with bank credit and installment payments. 2. Very small units in catering, trade, and services to be given away to employees.

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