ESOPs: The 'Trojan Horse' of the Antitakeover Realm

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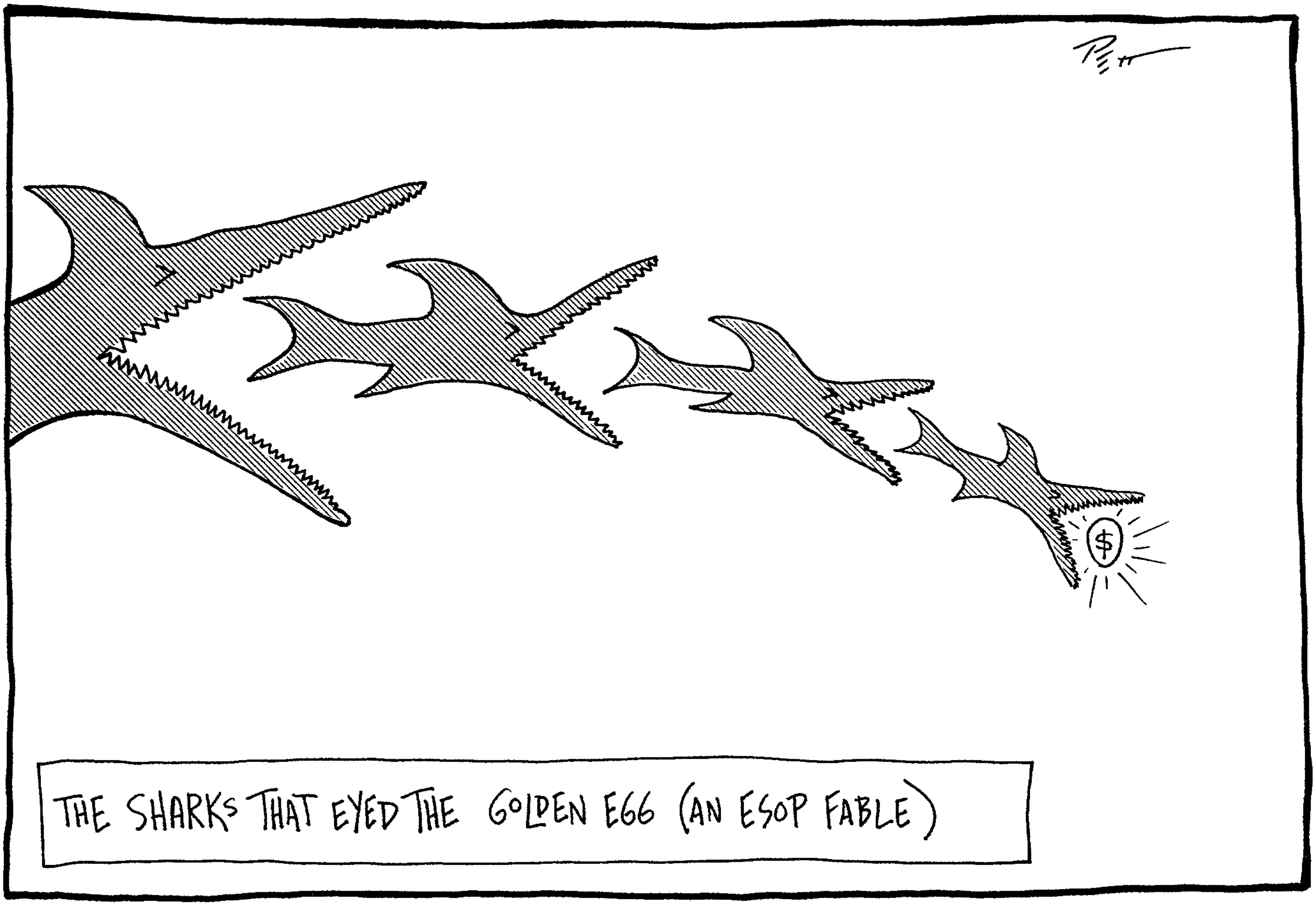
Management has been using the ESOP as an effective antitakeover tactic. But the hordes of employees inside an ESOP may strike the hand that created it.

In recent years, many articles have been dedicated to keeping corporate executives abreast of the multitudinous benefits offered by employee stock-ownership plans (ESOPs). Apparently such literature has served its purpose well, for it is estimated that 200 public companies have set up ESOPs during the past two years alone. In their generic form, pension funds now account for more than $1 *trillion* worth of assets in the U.S.—providing the impetus for one writer to dub ESOPs "the sleeping giants of capitalism" (Finley 1986). The potential power represented by such vast wealth should cause even the most languid of board members to stand up and take notice.

A turn of events, however, has called into question the very foundation of many such plans. In their most recent incarnation, ESOPs are increasingly utilized as mechanisms for fending off the advances of hostile corporate suitors. Rather than being implemented at the behest of employees, such plans are enacted by management—largely, some would argue, as a means of maintaining the existing corporate governance. The antitakeover motivation behind an ESOP stands in distinct contrast to the usual reasons for employing such an ownership structure. More importantly, such an impulsion may well violate the very spirit of ESOP regulation.

WHY AN ESOP?

It is unlikely that the numerous advantages of ESOP formation have been lost to even the most casual reader of 'mainstream' business periodicals. In 1974 Congress created what one writer recently christened the "industrial homestead act" (Grover et al. 1989). Incentives were offered to those businesses willing to make employees part-owners of the corporation. Both conservatives and liberals are reported to have embraced such legislation—although, as one might expect, for differing reasons. Conservatives are said to view employee ownership as a means of strengthening the underlying capitalist system: worker alienation is reduced, productivity is stimulated, and managerial control is legitimized. By contrast, the attraction of employee ownership for liberals is the resultant empowerment of the working class. Interestingly,



empirical support for the claim(s) of both conservative and liberal have been tenuous at best—a point we will return to momentarily.

Several financial advantages accrue to those corporations forming an ESOP. The most obvious of these are the tax savings engendered under such a plan. Not only is the interest on ESOP-funded debt an allowable tax deduction; the dividends paid on ESOP-held shares and principal repayments may be structured for deduction as well. However, the financial advantages are not exhausted with tax incentives for the corporation itself. In the typical scenario, contributions to ESOPs are leveraged through institutional debt channels. As ESOP legislation makes allowance for lenders to treat fully one-half of the income they receive on an ESOP loan as a tax deduction, financial institutions routinely offer attractive ESOP-funding rates (typically 1.5 percentage points below normal borrowing cost) to their corporate clients.

Additionally, many corporations have taken advantage of the fact that ESOPs are a form of defined-contribution pension plan. Savings can be substantial for the enterprise using an ESOP as a substitute—in whole or in part—for more traditional pension arrangements. Such savings are magnified to the extent the corporation is able to contribute stock rather than cash to the plan. Additionally, several companies have now reduced or dropped post-employment medical coverage; in such cases, former employees are permitted to draw against the ESOP for purchase of personal medical coverage.

The favorable tax treatment afforded the various constituencies involved with ESOP funding is largely premised upon the belief within Congress that ESOPs strengthen workers' stakes in the free-enterprise system and so increase the productivity rate (a matter of grave legislative concern). We can immediately recognize in the Congressional conviction the view of human nature undergirding economic analysis: man is hopelessly self-serving. Employee share ownership is purported to provide an incentive for hard work as a means of protecting one's personal investment. This conservative argument in defense of ESOPs remains empirically unsubstantiated.

MECHANISM FOR PARTICIPATION OR INVESTMENT?

The careful reader of the vast amount of literature concerning ESOPs cannot help but be struck by the distinctions drawn between ESOPs and employee participation programs of one variety or another. Economist Alan S. Blinder (1989), while positing that "employee participation may be one of the keys to higher productivity," notes there is only the weakest of evidence suggesting ESOPs raise productivity. Worker participation exists in a multitude of forms, including profit-sharing, decision-making rights, and unionization, as well as individual or collective claims to assets of the firm (with ESOPs perhaps being the paradigmatic example).

Substantial anecdotal and empirical evidence exists to support the claim that participation leads to increased productivity (a full explication of these findings is best left to a future discourse). Examination of several facets of direct employee participation may serve to illuminate the differences between such approaches and ESOPs, and thereby help to account for the productivity differences among such arrangements.

Within the traditional corporate governance ethic, owners have far-reaching responsibilities for the firm as a whole. It is expected that both directors and managers will honor their trusteeship obligations to organizational stakeholders. Absent direct participation, however, the relationship of trustee to trustor is necessarily paternalistic. It is left to the agent to determine how the needs of the principal are best met, and this absent any direct input from said beneficiary. Conversely, the pluralism characteristic of participative forums affords organizational constituencies direct access to decision-making channels—and may in large part account for the productivity gains associated with such arrangements. Within the current context, it is noteworthy that *direct participation is not an inherent characteristic of ESOPs.*

Organizational decision-making processes are as much at issue within participative approaches to management as are decisional outcomes. The astute manager recognizes that controlling the inputs to the decision process is of fundamental importance: organizational research reveals that managers consider access to and control of information to be foundations of their power. Nonetheless, firms committed to participation allow employee-generated issues to find their way into the corporate boardroom. Managerial power sharing is therefore essential to successful implementation of participative programs. It must be noted, however, that—as with direct participation—*direct power sharing is not an inherent characteristic of ESOPs.*

The modest claim being advanced so far is that ESOPs do not imply participation. Not only are managers conscious of this fact: employees are as well. Suffice it to say at this juncture that most employees view their ESOP holdings primarily as an investment, rather than as a mechanism for accessing organizational decision processes.

THE ESOP AS TAKEOVER DEFENSE

Polaroid was the first company to successfully employ an ESOP as an antitakeover tactic. On its face, using an ESOP to fend off a hostile takeover would seem to violate the intent of Congress in establishing the generous financial incentives outlined above; after all, resistance to hostile takeovers likely has the effect of reducing, rather than increasing, corporate productivity. Key to Chancery Judge Carolyn Berger's decision in allowing Polaroid's ESOP takeover defense to stand was the crucial fact that Polaroid has a demonstrable historical commitment to employee participation. The combination of employee participation and ownership was considered to be in the best interest of both employees and shareholders.

The ramifications of this legal decision are legion. Over one-half of U.S. corporations—including Polaroid—are incorporated under Delaware charters. Delaware law requires corporate suitors to acquire 85 percent of a target company's shares to complete a merger. What this means practically is that the majority of U.S. firms are able to fend off hostile takeovers by controlling a distinct minority (15.01, or 15.001, or 15.0001 percent) of their voting shares of stock. And for many companies the ESOP represents the least-cost alternative for achieving this antitakeover objective.

This tactic has not been lost to those involved in recent takeover frays. Continental Airlines agreed to sell a majority share block to an ESOP as a mechanism for defending the company against the advances of Texas Air. This attempt was ultimately unsuccessful, but not because of the inherent unsoundness of the planned defense itself. Legislative maneuvering within the Civil Aeronautics Board had the effect of removing significant takeover obstacles, providing the impetus for Continental's bankers to withdraw financing for the ESOP transaction.

Lightolier used a similar antitakeover strategy against Criton Corp.: a minority share block was issued to an ESOP in exchange for a long-term promissory note. The tactic was effective in staving off a hostile takeover until Lightolier could woo a white knight into coming to its defense. Eventually, Lightolier's board offered its support to a tender offer advanced by Bairnco Corp. at a price substantially above that proposed by Criton.

Frank Klaus' takeover bid for Hi-Shear Corp. was similarly thwarted. Sale of corporate stock to an ESOP was only one of a number of share transfers to friendly third parties. Klaus was narrowly defeated in a number of close stockholder votes. Ultimately, Midwood Industries, Inc. attained a controlling interest in Hi-Shear.

Graniteville Co. used an issuance of common stock to a newly created ESOP to spurn the advances of Southeastern Public Service Co. As with the above cases, efforts by the corporate suitor to have such transfers of ownership to ESOPs set aside through judicial process failed. Finding themselves unable to effect a purchase of Graniteville themselves, the board eventually succumbed to new advances by Southeastern.

The takeover defense capacity of ESOPs is understated to the extent the corporation has a number of minority stock interests within its grasp. The case of Grumman Corp. is illustrative. In an attempt to fend off a takeover by LTV Corp., Grumman announced plans for repurchase of a significant number of its shares on the open market. Grumman already controlled the vast stock holdings within employee pension and investment plans: Grumman officials served as plan trustees. It therefore appears to be more than coincidental that the employee pension plan was commensurately involved in purchasing Grumman stock. Though the merger was finally blocked on antitrust

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grounds, the Labor Department obtained a judgment that pension plan trustees had breached their fiduciary duty.

The above cases illustrate the great utility of ESOPs as an antitakeover tactic. However, a host of issues are raised. The first—and possibly easiest to address—concerns the value added to the firm's owners through such defensive posturing. As observed in a recent Business Week cover story (Farrell and Hoerr 1989), "it doesn't take a rocket scientist to figure out that the current wave of ESOPs is occurring mainly because it saves money in the short run, even if productivity doesn't go up." This is all the more true if ESOPs are used to quash takeover efforts. During the two-day period following announcement of a hostile bidder's plan to abandon its takeover attempt, the stock price of the target firm can be expected to drop by nearly 10 percent. Anticipation of an unfavorable outcome may largely account for the fact that an average 17 percent decline in stockholder wealth occurs between the time a corporate restructuring is announced and any contest for control of the corporation is finally resolved.

Corporate management plays a central role in the outcome of takeover attempts. Self-interest would dictate that managers become territorial, resisting efforts aimed at eroding their control of the organization: after all, 52 percent of a target firm's executives will no longer be with the acquiring firm three years after a merger or acquisition. However, to the extent that management neglects to have an eye toward shareholder wealth maximization, such leaders tend to violate their clear fiduciary responsibility to the owners of the firm. This is especially relevant when contemplating the profound impact managers have with respect to takeover defenses. Researchers conducting a recent in-depth analysis of 39 takeover bids report that, of the 25 cases in which management actually implemented defensive responses to takeover overtures, only three mergers were consummated. Hostile raiders were successful in fully one-half of the remaining bids.

This is not to suggest that corporate management bears exclusive blame for lapses of fiduciary responsibility to shareholders. Failure at a second level is indicated as well: the board of directors. The board is ultimately accountable for all organizational action. In an age of diffuse corporate ownership, the trusteeship role of those in governance is amplified. Under such conditions, directors have a clear obligation to act as the representatives of a diversity of ownership interests. While this is admittedly a difficult task, it is equally apparent that self-interest is not to be the touchstone by which the quality of organizational action is assessed.

MECHANISM FOR CONTROL OR INVESTMENT?

The issue of corporate power is worthy of further examination. Historically, ownership has represented control. One of the fundamental premises supporting managerialism, however, belies such a view: under conditions of diffuse ownership, corporate power necessarily coalesces in the hands of management. Several premises undergird this perspective:

- *Mankind is basically self-serving* (and this consideration overrides any countervailing fiduciary obligations);
- *The interests of owners and managers are incommensurable* (irrespective of what the literature on consensus-building might suggest);
- *Ownership dispersion necessarily leads to a loss of control on the part of shareholders* (in spite of collective efforts on the part of stockholders to influence corporate activity).

If the above hypotheses are true, governance structures are characteristically elitist rather than pluralistic. It is not difficult to find evidential support for corporate elitism. One recent study has found that within fully 82 percent of U.S. companies the CEO of the firm simultaneously serves as chairman of the board (Dalton and Kesner 1987). Such positional power can only be legitimate to the extent that it is exercised on behalf of shareholder interests. Even under such conditions, however, it is difficult to imagine how CEO duality fails to represent a conflict of interest, as the board is charged with monitoring and evaluating top management.

Only extremists have suggested that ownership should not be trump when the competing claims of organizational constituencies are at issue. Within Western society property ownership is considered a fundamental right—and among the firm's stakeholders it is only shareholders who hold a property-based interest in the firm. Property law informs us that ownership entitles one to the exclusive use (read *control*) and enjoyment of one's property, so long as the rights of others are not infringed upon by said usage.

The heart of the current discussion revolves around the claim that ownership represents control. Legally, the answer is unequivocally *yes*. However, under conditions of diffuse ownership—as is typically the case within the corporate ownership structure—an individual owner's stake in the firm may be so minute as to make claims of control moot. The fact that ESOPs represent a form of pooled ownership is said to mitigate the effects of ownership diffusion, thus accounting for liberal support of ESOPs as a mechanism for empowering the working class.

The assumption underlying such a view is that employee-owners control the ESOP. This is not, however, the norm. As a company perk, in some instances ESOPs fall under the direct purview of management—although more often employee ESOP shares are held in trust for employees until programmed dispersal dates (with trustees frequently appointed by management). Even under the most common scenario, in which banks fulfill the trusteeship function, corporate executives may have 'real' control "[b]ecause banks are dependent on management in all aspects of such plans, the ES[O]P strengthens management control" (Dye 1985). Finally, standstill agreements in which large block stockholders agree to vote with management for some period of time may have been put in place at the occasion of ESOP inception—again effectually transferring ownership control of the corporation to management.

Such observations call into serious question the claim that employee control necessarily accompanies ESOPs. At best, it might be said that ESOPs represent latent (as opposed to active) organizational control. Latent power is properly understood as a constraint on managerial decision making. This formulation suggests that a wave of shareholder activism with respect to the operation of ESOPs would likely have a profound effect upon the parent corporation. Even under such conditions, however, it is unlikely that employees would gain significant operational control over the corporation: shareholder influence is largely limited to financial functions. Given this, it is clear that *direct control is not an inherent characteristic of ESOPs.*

This perspective finds support in the views of ESOP contributors themselves. Recent research has examined the expectations employee shareholders bring to their ownership roles. The general hypothesis that employees expect profits, rather than control, from ownership has been empirically substantiated. Employee owners are indistinguishable from non-employee shareholders in their belief that the benefits of stock ownership are limited to the profits generated by invested capital. Interestingly, this finding has implications for employee satisfaction: employees with high ownership interests in the firm who perceive that the company is sound are likely to be more satisfied than employees with high ownership interests who believe business to be poor (perceptions of how well the firm is doing by those with low financial stakes is presumed to have little effect upon their satisfaction). Therefore, the reality employees themselves construct dictates that direct control is not an inherent characteristic of ESOPs.

Beyond the above arguments demonstrating the tenuousness of the ownership/control link are several pragmatic concerns. Employees generally honor the Wall Street rule, using their limited boardroom clout to support management. And why should this not be so? Any individual employee-owner is so far removed from having even the smallest measure of control over operational decisions that such an idea is laughable. Conversely, such an employee-owner's weal or woe is inextricably linked to managerial discretion. Even granting the collective power of ESOPs, which has been shown to be a matter of some dispute, it is not likely that employees will find it in their best interests to buck management. And this is at no time more true than during the thick of a hostile takeover battle.

THE FABLE OF THE TROJAN HORSE

Within the takeover milieu, ESOPs represent an effectively free good serving to entrench existing management—thus accounting for their attractiveness as an antitakeover device. To the extent that funding for ESOPs can be advanced without loss of managerial control, ESOP formation closely mirrors the effect of a leveraged buyout: "In most buy-outs, the managers put up a fraction of the total purchase price but receive a *de facto* controlling interest. . . . One or more financial institutions provide the rest of the equity finance and the long-term borrowings secured on the assets of the business" (Green 1988).

On their surface, ESOPs represent a gift to management. As employee-owners tenaciously hold to their conviction that shareholder property rights entail nothing more than investment opportunity, the latent power of ESOPs will never erupt into active authority. Wooed into complacency by the hope of abnormal returns on their investment, employee-owners become largely invisible to management, and the power resident in one of their richest assets lies dormant. There is nothing, however, to prevent the tables from turning.

Thus the metaphor: We are told in Homer's *Iliad* that it was Odysseus who conceived the plan whereby the Greeks gained entrance to Troy. A great horse was constructed of wood, with a hollow belly large enough to hold many warriors. The Trojan Horse was left on the plain. To give the impression they had abandoned the war effort, the Greeks burned their camp and set sail—although they only sojourned to the refuge of a nearby island. The Trojans were convinced to pull the gigantic horse inside the gates to honor Athena. That very night, the soldiers crept down from the horse, killed the sentries, and opened the gates to let the Greek army in. Troy was looted; fires were set throughout the city; the inhabitants

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were massacred; the surviving women were divided among the Greek leaders for their pleasure.

ESOPs hold the same attraction for management as the wooden horse did for the Trojans—they promise to be the mystical cure to a plethora of problems. At the same time, they represent enormous hidden potential. Having found the Trojan Horse of ESOPs standing at the portal of the corporate edifice, management has been all too quick to bid it enter. The long-term import of such action remains largely unexamined; one can only hope it will not represent Troy revisited.

THE MATTER OF ETHICS

One must be extremely cautious in ascribing ignoble intent to managers. Managerial motivation has been the topic of empirical inquiry. Before attention is turned to the final issue of the ethics of utilizing ESOPs as an antitakeover defense, a brief note concerning one study, which addressed the performance consequences of defensive structural changes (Dann and DeAngelo 1988), is in order.

The general finding was that "stockholder wealth declines on average when managers respond to attempted hostile takeovers with defensive changes in asset and ownership structure [such as ESOPs]." Approximately one-half of the restructurings studied involved attempts to create a management-controlled block of voting stock through issuance of new securities to parties friendly to management, including ESOPs. In fewer than 3 percent of the cases were the planned restructurings voluntarily put to a stockholder vote.

The hostile bidder (or a competing bidder) prevailed in roughly two-thirds of the takeover contests. What is notable about these antitakeover losses is that shareholder gains were associated with nearly all such acquisitions. In the remaining instances stockholders typically experienced large share-value declines upon withdrawal of the takeover bid in the face of resistance by incumbent managers.

Such findings call into serious question the fiduciary faithfulness of management as well as the ethics of wielding ESOPs as antitakeover defenses. "Not only are such activities [as managerial antitakeover posturing] considered by many to be an attack on shareholder wealth by management itself, but they also suggest a serious erosion of the important concept of corporate accountability" (Finley 1986). This would not be a serious problem if there was goal congruence between management and shareholders in the face of hostile takeovers. However, to the extent that such interests are not congruent, and organizational control is divorced from ownership, it is not likely that managerial resistance to a hostile takeover fairly represents the best interests of stockholders.

It is not, however, only the interests of generic corporate owners that count in such an analysis. Other stakeholders gain greater or lesser legitimacy as they are perceived to have both the right and capacity to participate in organizational decision processes. "The right derives from one's being influenced by the issues under consideration; the capacity of a legitimate stakeholder refers to one's possessing some degree of power over the domain" (Gray and Hay 1986). Given this reading, it is clear that ESOP contributors have a high stake in antitakeover maneuvers.

This raises a major ethical problem. Corporations are most properly understood through reference to inclusive social property rights rather than unbridled private property rights. It is not acceptable to own or control people in the same manner inanimate objects are controlled—to do so would approximate slavery. "Consequently a private property right to own and transfer firms which totally excludes stakeholders like employees from control is morally contentious" (di Norcia 1988). This is all the more true to the extent that these same employees hold a substantial collective ownership position in the firm.

Some might be willing to dismiss even this most fundamental concern if there were not evidence to suggest the possibility of substantial downside risk for employees whose resources are committed to ESOPs. For example, ESOPs typically make pensions much less certain. A standard pension arrangement, one funded with cash instead of stock—assuming a $40,000 annual starting salary with 5 percent raises per year—would yield an employee retirement income of $58,381 per year after 30 years of corporate service. If the company's stock were to appreciate at an aggressive annual rate of 12 percent, under an ESOP this same distribution would amount to $89,377 per year—substantially above the rate for the conventional defined-benefit plan funded with cash. However, if the corporate stock appreciated at a modest 4 percent per year, the annual pension would amount to only $26,319—shattering hopes of golden years spent on the French Riviera.

Questions as to the appropriateness of tying pension benefits to ESOPs raises yet another issue: whether or not using ESOPs as an antitakeover tactic is in the firm's long-term interest. It has already been suggested that antitakeover measures in general erode shareholder value. A further claim has been advanced: "ESOPs rip off the employee if they are used solely as a takeover defense by entrenched management . . . [because] . . . [c]ompanies insulated from market forces often perform poorly" (Farrell and Hoerr 1989). The assumption underlying this claim is that successfully rebuffing a hostile bidder lessens the effects of free-market competition, thereby allowing inefficient firms to proliferate. To the extent that managers maintain control over ESOP holdings (and are thereby effectively insulated from hostile takeover), ESOPs represent a contractually inefficient arrangement.

The long-term effects of utilizing ESOPs as mechanisms for resisting takeovers are not yet known. However, at least one article has suggested that "'a new type of public corporation' is emerging that may redefine the stakes held by shareholders, managers, and employees" (Farrell and Hoerr 1989). Such a belief may portend radical changes in the operational control of major U.S. corporations. A broad distribution of decision-making rights is characteristic of participative firms. In many organizations, such rights belong to employees as a direct consequence of ESOPs. Yet these same rights largely lie dormant because employee-owners, for the several reasons outlined here, have granted managers control of their ownership interests in the firm. If employees were to recognize the operational control that ownership might represent, corporations would likely adopt the visage of participative firms virtually overnight.

Although managerial intent might be absolutely impossible to verify, corporate administrators have nonetheless taken a beating in the popular press for their central role in the formation of ESOPs as a mechanism for fending off hostile raiders. Essentially all managers involved in such restructurings have claimed the takeover defense feature of ESOP formation to be of at best secondary concern in the decision to advance such plans, but abundant evidence has been offered to suggest that as long as managerial control can be maintained, ESOPs serve managerial interests almost too well.

Irrespective of motivational concerns, managerial caution is enjoined. The Polaroid case is advanced as a paradigm of how ESOPs might be used as an antitakeover tactic. The fact that Polaroid has had a sustained history of sanctioning employee empowerment in the workplace should not be lost to the reader (after all, such evidence was not lost to the courts). It is apparent that the use of ESOPs with antitakeover intent necessitates some measure of prior efforts at establishing codetermination.

Many managers have seen that successful resistance to takeover advances provides only short-term relief. White knights, for example, often prove to be a shade of gray: some critics have gone so far as to argue that the loss of managerial independence occasioned by a white knight's post-acquisition restructuring has a more deleterious affect upon the acquired company than a hostile takeover. The beauty of ESOPs in fending off hostile bidders is likely to lose its bloom as well. Once a legion of employees gain an ownership interest in the firm, they are much more likely to embrace a collective consensual agenda than are the faceless mass of stock-certificate holders.

The first rule of human enterprise is to not knowingly do harm. Those in the business environment are not immune from this exhortation. There exists a strong temptation to advance corporate (or managerial) interests through encroachment upon the rights of organizational constituencies. Although our economic system is premised upon a view of humans as self-interested, unethical behavior can never be justified on economic grounds. Were managers to hold fast to this principle, the ethicality of ESOP formation would not likely be of concern—corporate takeover target or no. ❒

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