Making an ESOP Work For You

A guide to communications, organizational culture, and participation for companies considering an ESOP.

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How do you really make ESOPs work?

With nearly three decades of data on ESOP companies, researchers have a clear answer: communications, organizational culture, participation and other "soft" issues often determine whether an ESOP is a success—or a disappointment.

Company leaders clearly have an obligation to ensure that the legal, financial and administrative foundations of the ESOP are solid, but they should not let those responsibilities crowd out the human side of employee ownership. The quality of the initial presentation about an ESOP can determine whether the work force reacts with enthusiasm, indifference, or cynicism.

This booklet highlights research on the psychology of ownership and employee ownership's performance effects. It describes tools and effective ESOP-implementation strategies, as well as some common pitfalls. This booklet also introduces Ownership Associates, a consulting firm exclusively dedicated to helping companies maximize the return on their investment in employee ownership.

1. Research Highlights

Since their inception in 1974, ESOPs (Employee Stock Ownership Plans) have been gaining prevalence in the United States. Current research estimates that there are approximately 9,000 ESOPs and a total of 8.2 million ESOP participants in the United States, representing 7.7% of private-sector employees.[1]

ESOPs and Corporate Performance

ESOPs are associated with positive outcomes in the companies that have adopted them. ESOP companies, on average, outperform non-ESOP companies by approximately 2.3% on a number of measures, such as sales and employment growth.[2]

- **Productivity improves** by an extra 4-5% on average in the year an ESOP is adopted, and the higher productivity level is maintained in subsequent years. This one-time jump is more than twice the average annual productivity growth of the U.S. economy over the past 20 years.[3]
- **Sales increase:** Adoption of an ESOP is associated with an average increase of 2.3% in sales per employee.[4]
- **Retirement Assets:** Initial results indicate that on average ESOP participants have 2.5 times more retirement assets than non-ESOP participants.[5]
- **Firm survival is higher:** ESOP companies file for bankruptcy less often than non-ESOP companies. One study tracking U.S. public companies from 1983 found that those with substantial employee ownership stakes were 20% more likely than their industry counterparts to survive through 1995.[6] Similarly, a study tracking all privately-held companies with ESOPs in 1988 found they had higher survival rates than closely-matched firms without ESOPs.[7]

Studies have also investigated the effects of employee ownership on employee attitudes and behavior. Most find higher organizational commitment and identification under employee ownership. On job satisfaction, motivation, and other behavioral measures studies are mixed between finding favorable and neutral impacts of ESOP ownership.[8]

For original articles, summaries, and briefing papers about the relationship between employee-ownership and corporate performance visit
www.ownershipassociates.com

The implication of the research summarized above is that ESOPs are beneficial *on average*. Ongoing research seeks to determine what factors separate successful ESOP companies from the others. The results so far, summarized in the next section, are dramatic.

Where Does Success Come From?

The National Center for Employee Ownership states that "*Researchers now agree that 'the case is closed' on employee ownership and corporate performance… We can say with certainty that when **ownership and participative management are combined**, substantial gains result*."[9] [emphasis added]

For example, one researcher found that employee ownership companies *with participation* have higher sales growth rates (5%) and higher employment growth rates (13%), leading him to conclude that "*the combination of employee ownership and significant participation makes it possible for employee ownership companies, on the average, to have an advantage unavailable to their competitors*."[10]

The research shows that the key to success for ESOP companies is participation, but it has failed so far to provide a clear answer about what exactly defines "participation." Along with many other researchers, Ownership Associates has carried out and supported a number of research projects aimed at answering that question. We start with the assumption that employee motivation is part of the equation. Based on this assumption, we argue that "*the way people **interpret** ownership has a more direct impact on company performance than legal structures or vision statements do*."[11]

A strong ownership culture separates successful ESOP companies from others.

The workforce understanding of ownership is what we refer to as an "ownership culture"—defined simply to mean the extent to which members of an organization think and act like owners of the organization. This definition is broad enough to include participative management as well as a number of other areas of company operation.

In short, a strong ownership culture is often what separates successful ESOP companies from others.

The Psychology of Ownership

The motivational impact of employee ownership depends more directly on people's understandings about ownership than on the actual parameters of the plan. The vesting schedule, distribution mechanism, future changes in share value, ERISA, dividend payments, and many other factors affect how employees feel about the company, but all of these operate through the psychology of ownership.

Writing in the *Psychological Record*, two researchers report that a sense of ownership has three primary determinants:[12]

> ***"Means of acquisition."*** People need to understand the mechanism by which they became owners and to accept that mechanism as legitimate. This implies an understanding of the ESOP and the extent to which it gives them the legal status of owners.
>
> ***"Attachment."*** As used in the research, "attachment" means "intimate knowing." It entails a high degree of knowledge about the company and its operations.
>
> ***"Control."*** In the context of this research, "control" does not mean absolute decision-making authority, but it does imply a degree of influence over the company and the daily work experience.

A psychological sense of ownership has three primary determinants.

More recently, Jon Pierce and Loren Rodgers noted the similarities between these three determinants of psychological ownership and the three major components of ownership rights as discussed by legal scholars. They note that the bundle of ownership rights includes: "(a) a right to some share of the owned object's physical being and/or financial value, (b) a right to information about the status of that which is owned, and (c) a right to exercise influence (control) over that which is owned."[13] Two of the three points are essentially identical between these two studies—while the relationship between "means of acquisition" and financial value is indirect, both rely on a solid understanding of the specifics of how an ESOP works.

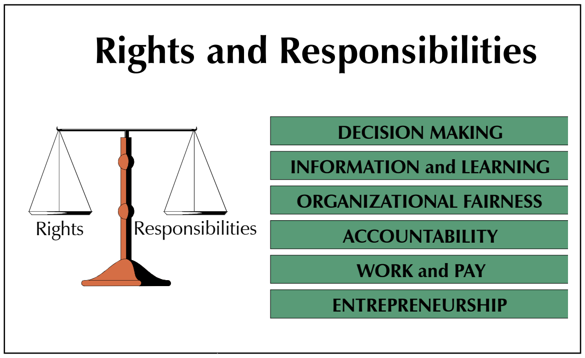
In practical terms, these studies and others support an applied approach to employee ownership involving a number of specific features:

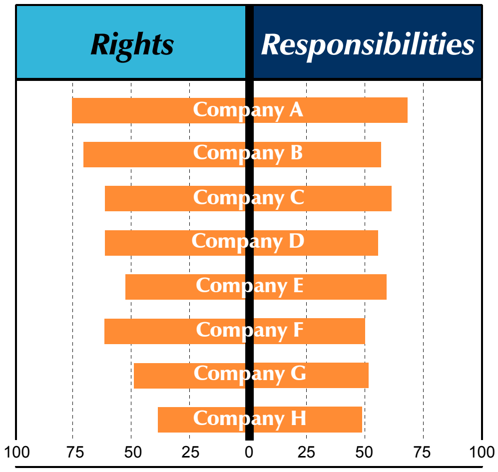
- **Education on ESOP Basics**
  ESOP companies need to provide adequate opportunities for employees to understand how they will receive benefits through the ESOP and what determines the timing and value of those benefits.
- **Advanced Communications Systems**
  Employee-ownership companies tend to have stronger and more predictable systems for information sharing, as well as training and education to support people's ability to use that information.
- **Employee Voice**
  Companies with strong ownership cultures generally have extensive structures to involve a substantial number of employees in decision making, and they often extend a degree of employee voice to strategic, company-wide issues.
- **Linkage between Rights and Responsibilities**
  Many people's instinct is that employee-owners have a significant number of organizational "rights" relative to traditional employees. A more mature understanding of employee ownership agrees, but also insists that for each of these new perceived rights, employee-owners necessarily accept a linked responsibility as well.

The final point on rights and responsibilities deserves greater attention. Ownership Associates has found that for each right that a member experiences, in a healthy ownership culture, he or she accepts a corresponding responsibility. If, for example, I believe I have the right to have my input considered in decision making—the right to have "voice"—then I must accept the responsibility to exercise that right responsibly. I will make sure my contribution is positive by deferring to experts when necessary, by studying the issues, by considering the wellbeing of the company as a whole, etc. This is the "responsibility for organizational citizenship."

Together, the Right to Voice and the Responsibility for Organizational Citizenship make up "Decision Making," the essence of what people are discussing when they refer to "participative management."

Decision Making is one of the six rights-responsibilities pairs in an ownership culture. Another of the six is "Information and Learning," which requires both that employees are able to exercise their Right to Know information about the company and that they accept their Responsibility to Learn how to use that information to make the company work better. All rights-responsibilities pairs are illustrated in the graphic to the right.





One implication of the Rights and Responsibilities Framework, which has been supported at all companies that have taken the survey, is that rights and responsibilities are positively correlated, as reflected in the data to the left, taken from *The Ownership Culture Report*.[14]

For more information about rights and responsibilities, including research and management implications, see page 15 of this booklet, which indexes a number of free resources available from Ownership Associates.

The following section of this booklet outlines strategies designed to promote a healthy and successful implementation of employee ownership, rooted in the research data about the psychology of ownership.

2. Basic Strategies

The strategies adopted by ESOP companies fall into three broad categories with regard to employee-ownership.

Strategy 1: The ESOP as a Retirement Benefit

Some companies want the ESOP to serve simply as a part of their employee benefit package. They do not expect it to change the way people feel about the company or the way they perform their jobs. In this scenario the benefit to the company is relatively small and results primarily from the tax advantages of ESOPs and the ESOP transaction.

To adopt this strategy effectively, company leadership should clearly state from the announcement of the ESOP that employees should not expect a change in company operations or in their roles as employees. Ownership Associates advises companies to use the phrases "stockholder" or "beneficiary" instead of "owner" and to promote the ESOP as an employee benefit.

Strategy 2: The ESOP as a Performance Incentive

The second strategy seeks to engage employees by aligning the financial interests of the company with the financial interests of the employee. This strategy seeks to create a company in which every employee feels an individual "profit motive" to maximize the success of the company. Strategy 2 yields vastly different results from company to company, depending on a number of factors, including workforce characteristics, management commitment, and prudent implementation.

Making this strategy work requires a company to invest greater time and effort than in strategy 1. The company needs to focus on three components: employees need to have the means, the motive, and the opportunity to make the company succeed.

The ***means*** is each employee's knowledge about how she contributes to company success. Each employee needs to be educated to understand the "critical numbers" that measure how well she is doing her job. Each employee needs a consistent supply of information to track company performance and current conditions, as well as the education to understand that information.

For more about ESOPs as an incentive, see the OA publication The Ownership Incentive*, available online or by contacting Ownership Associates.*

The ***motive*** to make the company succeed is that as the company's performance rises, its stock value goes up and makes the individual accounts within the ESOP more valuable. While these connections are obvious to people experienced with business, it does not follow that the mere *existence* of an ESOP is sufficient to motivate employees. They must *understand* the mechanics of the ESOP before they care about stock price, and if they do not have a rough sense for the valuation process, they have no reason to care about company performance.

Even when employees have the means and motive, the company needs to ensure that they have the ***opportunity*** to contribute to company success. The opportunity may simply be the way they do their jobs from day to day, but many companies have found greater success by getting employees involved in more ambitious and more participative strategies.

Strategy 3: The ESOP as Part of the Work Experience

This strategy seeks to engage employees as complete people rather than "hired hands," and aims to create the kind of company many people picture when they imagine employee-ownership.

Companies that use the third strategy successfully adopt it *in addition to* strategy 2—employees need to understand the financial underpinnings of the employee-ownership relationship as the foundation on which to build a new company culture.

This strategy aims to create the kind of company many people picture when they imagine employee-ownership.

Companies that adopt the third strategy generally have a deep leadership commitment to employee-ownership as a concept. They tend to believe the ESOP is not just a prudent decision, but an approach to business which has moral appeal. They create companies with a sense of community, family, and respect. They often explicitly encourage employees to explore and develop their human potential.

The research discussed in section 1 indicates that this strategy can be immensely successful. Still, it puts the greatest demands on the company in terms of education, communication, involvement systems, and planning.

3. Common Pitfalls

Employee ownership is a good business strategy *on average*. What can you do to make sure that your company is one of the success stories? Here are some of the common pitfalls in companies where employee ownership is a disappointment.

Failing to Support Supervisors and Middle Managers

Data from the Ownership Culture Survey™ indicate that middle managers and supervisors are consistently the employee group with the highest instance of cynicism about employee ownership. Supervisors and middle managers are expected to continue meeting operational goals, while they are also being asked to promote a change in organizational behavior—a change that may not be clearly defined, and which middle managers and supervisors are rarely involved in defining.

A low degree of buy-in by middle managers is especially significant since they are the "face" of the company to many employees. While it is tempting to blame middle management for this failure, company leadership must provide the tools, training and psychological safety the supervisors and middle managers need before they can enthusiastically support employee ownership.

Lack of Clarity

Different people have vastly different ideas about what changes they should expect from an ESOP. If the company's leadership is not careful to define what employee ownership means *now* and *at this company* people will assume that it matches their pre-existing expectations. Take the time to write a concise statement about what the ESOP means and what it *doesn't* mean. All senior managers should be familiar with it, and should be willing to consistently support the message. Consider having all company leaders sign the statement and posting it.

Company leaders must clarify what employee ownership means… and what it **doesn't** *mean.*

Avoiding the "Hard Facts"

Companies are often tempted to avoid discussing some of the ways in which ESOPs do not match many people's concept of ownership. We recommend that companies make sure to address the following issues:

- Participant legal rights
- Risks of ownership
- Joint ownership (as opposed to sole ownership)
- Beneficial ownership (as opposed to direct ownership)

These "hard facts" are most effectively presented in the context of ESOPs in the United States, including a capsule history and common practices by other ESOP companies.

Reliance on One Person

Having one "champion" responsible for ownership issues is an effective way to start a program, but it is rarely sustainable in the long run. Once your company has some momentum and a solid basis of understanding, it's time to make sure that there is an institutional structure in place to keep things rolling. Often an ESOP Committee is the best way to meet this need.

For more information about ESOP committees, including structural parameters and lifecycle, see the online resources section of the OA website.

Overselling the ESOP

Many company leaders "sell" the ESOP to employees, emphasizing the hopes and ideals the company has for employee-ownership. They may promise substantial changes in the day-to-day work experience. Unfortunately, overselling the advantages of an ESOP is the single most common way ESOPs lose credibility.

"Overselling" is the single most common way ESOPs lose credibility.

We recommend that companies first be sure which of the three strategies described in section 2 they plan to pursue and that they tailor all communications from the initial announcement of the ESOP accordingly. If a company is not sure which strategy it intends to pursue, we recommend framing the ESOP in terms of the less-ambitious strategy.

Some ESOP companies emphasize potential upside benefits without acknowledging the existence of new types of employee risk. Acknowledging risk is especially important in cases where reductions in wages or other benefits accompany the ESOP. Counter-intuitively, our research indicates that the employees most enthusiastic about ownership have a stronger than average understanding of risks.[15]

Dealing With Ownership Cynicism

Even in the strongest companies, some employees are cynical about employee-ownership. Our research using the Ownership Culture Survey™ finds that the number of cynics is typically around 27% of the work force, although that number varies widely, from a low of 14% to a high of 47%.

How much these cynics affect the company depends on a number of factors, including the type of cynicism, the number of strong believers, and the skill of company leadership in responding to the message of the cynics.

For more data about cynicism, including a discussion of different types of cynics, as well as ideas for responding to and pre-empting cynicism, see our free Ownership Culture Report*, "Ownership Cynics."*

4. Sample Year 1 Timeline

There are as many ways to approach an ownership culture as there are ESOP companies. While there is no recipe for a successful ownership company, the timeline below represents one approach that our clients have found to be effective.

1. Two to Four Months Prior to Establishing the ESOP

Senior Management Planning Meetings

- Clarify and Commit to an Ownership Vision
- Finalize Plans for ESOP Committee Structure and Goals
- Plan Announcement to Employees

2. One Month Prior to Establishing the ESOP

ESOP Preview for Middle Managers and Supervisors

- Introduction to ESOPs
- Preview Announcement, Gather Feedback

3. Month Zero: ESOP Establishment

Official Announcement of ESOP to Employees

- Why We Are Establishing an ESOP
- Outline of the Transaction
- Direct Ownership versus ESOP Ownership
- Overview of the ESOP as an Employee Benefit

4. Between Month 1 and Month 3

Introduction to ESOPs for Employees

- Basics: Participation, Allocation, Vesting, Distribution
- The ESOP Landscape
- Legal Rights of ESOP Participants
- What to Expect

5. Between Month 3 and Month 10

Preview for Managers of Employee Survey and the Rights and Responsibilities of ownership. (See #7 below.)

6. Between Month 4 and Month 11

Employee Attitude Survey / Focus Groups

One example of an employee survey is the Ownership Culture Survey™ (OCS), which is used exclusively by employee-ownership companies. It provides fully tested and normed survey data to help companies identify strengths and weaknesses in their ownership cultures. In addition, surveys are a good way to increase the sense of a give-and-take dialogue within the company.

7. Between Month 5 and Month 12

Workshop on ESOPs and Employee Ownership.

This workshop focuses on the cultural concepts that are part of the way people conceptualize ownership, especially in terms of rights and responsibilities. It can be independent of the OCS, but the combination of the survey and this workshop is powerful. It can be timed to coincide with the distribution of account statements.

- The Rights and Responsibilities of Employee Ownership
- Results of the Ownership Culture Survey™
- Questions about ESOP Mechanics
- ESOP Game
- Preview of the ESOP Account Statements

5. Ownership Associates Services

Ownership Associates is a consulting company founded in 1987 in Cambridge, Massachusetts, to serve the needs of the employee-ownership community. Since then, it has maintained its focus on employee-ownership while expanding its area of operations to include a European office in Mondragón, Spain.

Ownership Associates helps clients harness the power of employee ownership. We work with companies at all stages of the employee-ownership process, including their first introduction to ESOPs and the challenging discussions about the practical meaning of ownership in day-to-day work life. We help companies develop long-term strategies about education, communication, employee involvement, plan design, and measuring progress.

Professional Services and Ownership Tools

Ownership Facts Training: A flexible tool chest of "nuts and bolts" training agendas, text and graphics to answer frequent questions about employee stock ownership programs. Ownership Facts is generally presented in sessions lasting between 45 minutes and 2.5 hours.

Communication Support: From an initial announcement to ongoing communications, we can help ensure that you are presenting employee-ownership in a way that maximizes effect and minimizes confusion. We offer ready-made slides, sample meeting agendas, talking points, and a number of other tools to make your communications function as smoothly as possible.

Participation and Decision Making: Clarify expectations about the scope and meaning of employee involvement in decision making. Companies may also use the tools in this curriculum to develop management systems that are inclusive, efficient, widely understood, and broadly supported. (See also *Frontiers and Boundaries*, next page.)

Ownership Culture Survey™: The only employee-attitude survey designed specifically for employee-ownership companies. Measure the strength of your employees' feelings in different areas of ownership culture, and benchmark against our database of employee-ownership companies. This survey can be repeated on a periodic basis. Much of the value of the Ownership Culture Survey comes from measuring change over time, allowing companies to continue a dialogue with the work force and track changes in their ownership cultures.

ESOP Committee Development: Many companies choose to involve an ESOP communications committees in planning or implementing the activities on this and the previous page. Ownership Associates can help in clarifying and increasing the role of the ESOP committee.

Ownership Culture Training: Help employees understand their new roles as employee-owners. This program addresses common misconceptions about ownership and speaks to the concerns of "ownership skeptics."

Frontiers and Boundaries: Managing Ownership Expectations: One danger of ownership is unrealistic expectations about the roles that employees will have in decision making. At the same time, much of the potential power of ownership comes from wisely designed structures to harness the creativity of employees in contributing to company decisions. *Frontiers and Boundaries* is a set of tools, including a handbook, templates, and training modules designed to address both the psychological and business imperatives in creating realistic participative decision making structures in an ownership environment.

Ownership Strategies: Ownership Associates can serve as part of a transaction team, with responsibility for communications and employee relations. Companies that are already employee-owned rely on our expertise to understand the issues they are facing now and to plan long-term development strategies.

Business Literacy Training: Many companies seek to increase employees' understanding of the key numbers that drive corporate profitability in order to ensure that all employees know how they can most effectively contribute to company success.

Large-Group "Real Time" Culture Change: Based loosely on the "Work Out" model developed by General Electric, this ambitious activity allows for structured problem solving in "real time" and provides for follow-up research and proposal development.

Contact Ownership Associates for a proposal or a no-cost, no-obligation discussion of ESOPs and ideas for making sure that your company maximizes the return on its investment in employee ownership.

Web-Based Resources

Our website includes free resources, including case studies of successful companies, research by ourselves and others, tips for avoiding common pitfalls, guides for companies conducting employee surveys, ideas for creating employee participation, guidelines for communications programs, and much more.

Over 60 titles are available at no charge, including:

- ***Ownership Cynics*** shares research data about the skeptics of employee ownership, including where their skepticism comes from and what effects it has.
- ***Participation: Decision Making and Employee Ownership*** is the second in a series of *Ownership Culture Reports*, working papers on the quantitative study of ownership culture.
- ***ESOP Committees*** is a chapter from a book published by the National Center for Employee Ownership. It highlights the key developmental stages of most ESOP committees and the main task at each stage.
- ***Frontiers and Boundaries: An Introduction*** covers the "working parts" of a participative management system and the tools to plan, communicate, and implement a new system at your company.
- ***Who's Afraid of Ownership?*** draws on survey data from employee-ownership companies to ask about perceptions of risk, reward, and their relation to individual and company performance.
- ***Self-Direction and Employee-Ownership*** outlines three aspects of shared decision-making: autonomy, participation, and influence, and their relationship to productivity.

The Ownership Associates e-commerce site includes a number of ready-to-use products, including:

- ***individual survey items*** that companies may insert into their own internal surveys, with complete comparison data and chart-making templates for analyzing results.
- ***a number of briefing papers,*** each of which examines a specific area of interest to employee-ownership companies and summarizes the current state of knowledge on a single page—great for handouts to employees.
- ***PowerPoint slides*** on a number of topics—the slides come complete with speakers notes and are designed to integrate easily into company presentations.

Endnotes

Most articles are available at www.ownershipassociates.com.

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