October 2008

: Employee Ownership

INTRODUCTION:

The recent collapse of Bear Stearns and the class-action employee lawsuit filed against U.S. Sugar have drawn media attention to the potential negative consequences of employee ownership programs for stock-owning employees.[1] For many companies, however, employee ownership remains a viable and rewarding strategy to share equity and profits with employees. According to the 2006 General Social Survey, between one third and one half of all employees participate directly in company performance through various combinations of employee ownership, stock options, profit sharing and gainsharing.[2] Among the hundreds of highly successful public companies with some form of employee ownership are Apple, Google, Procter & Gamble, PepsiCo, and Starbucks.[3] Employee-owned companies also feature prominently on *Fortune* magazine's annual list of the *100 Best Companies to Work for in America*.

Employee ownership represents a powerful tool for managers to align company and employee incentives, improve company-wide performance, and show appreciation to employees. When the senior management of a company is firmly committed to a meaningful form of employee ownership, the opportunity exists to build an "ownership culture".[4] Within an ownership culture, each employee has a clear understanding of how the company makes money and of his or her role in generating profits. Employees receive frequent updates on how each group contributes to the company's ongoing performance, and opportunities are provided for all employees to contribute ideas and feedback. All of these contribute to a company's ongoing profitability, and spur internal entrepreneurship.

Employee ownership first generated attention among business academics when the phenomenon came to prominence in the 1970s. Since then, many case studies and numerous research studies have demonstrated the conditions under which employee ownership can work more and less effectively. Especially timely in light of recent events, employee ownership offers an interesting perspective into "the theory of the firm" and the ongoing debate over stakeholder and shareholder participation and responsibility.

Historically, employee ownership has been explored most extensively in accounting and entrepreneurship courses. However, the positive outcomes generated by the creation of "ownership cultures" at many companies offer lessons for other disciplines such as organizational behavior and marketing. This *Closer Look* scans the current landscape of employee ownership teaching in graduate business programs, and shares the perspectives of a leading academic and veteran practitioner about the salient lessons of this model of business.

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[1] See the following articles from the *New York Times*:
http://www.nytimes.com/2008/03/24/business/24deal.html?th&emc=th and
http://www.nytimes.com/2008/05/29/business/29sugar.html.

[2] General Social Survey, University of Chicago, National Opinion Research Center,
http://www.nber.org/papers/w14225

[3] An in-depth story of the founding of SAIC that comprehensively addresses the importance of an employee ownership-created culture to its initial successes can be found in the book by Robert Beyster, the company's founder: *The SAIC Solution*.

[4] See the National Center for Employee Ownership on the benefits of "ownership culture".
http://www.nceo.org/culture/index.html

AN ACADEMIC POINT OF VIEW:

Arthur A. Boni is the John R. Thorne Professor of Entrepreneurship and Director of the Donald H. Jones Center for Entrepreneurship at the Tepper School of Business of Carnegie Mellon University. His areas of expertise include new venture creation, venture capital investing, innovation and entrepreneurship in corporate environments, leadership in entrepreneurial companies, and the biotechnology industry.

On companies in which employee ownership is most successful: I think these models do best in companies where employee engagement, particularly with respect to customer service and knowledge-based innovation, are necessary for corporate success over the long term. In fact most companies should develop these attributes and cultures.

On the uniqueness of employee-owned companies: There are at least two issues here; structure and culture. Structurally employee owned companies have fewer external constituencies, e.g. investors, shareholders engaged in the governance structure. Hence there is more of a long term focus on company performance and employee and management voice in governance. This difference in structure of course translates directly into culture where behavior is much more focused in broad based engagement of employees in driving innovation and customer interface. These employees are encouraged to behave entrepreneurially since they have a real sense of ownership and control of their futures, rather than waiting for someone else to innovate or make a decision. My sense is that corporate culture is part of the DNA of a company and is best embedded from the beginning. Corporate cultures are very difficult to change once bureaucratic structures become entrenched.

On the potential disadvantages of employee ownership in closely-held firms: I think the principal disadvantage is if the company needs to make a significant change in business model, to make structural changes, or to access public capital for the first time to accelerate growth. The second thing that comes to mind is if the company desires to make a significant acquisition to facilitate inorganic growth and the acquired company has a very different culture and incentive system.

On the management lessons these companies can offer MBA students: People and leadership are the magic ingredient and driver of corporate success. They provide the sustained differentiation and advantage from a competitive perspective. So the principal lesson is that sustained innovation is driven by a culture that encourages broad based engagement of employees into the corporate culture, gives them the freedom to operate and take risks, and enables and encourages them to be close to the customer. This is best achieved by sharing ownership as broadly as possible with employees so that they are rewarded directly by the overall success of the organization, as well as from their individual contributions. It's the "rising tide lifts all boats" principle.

A PRACTITIONER POINT OF VIEW:

Steve Voigt is President and CEO of King Arthur Flour, America's oldest flour company. The company's website describes King Arthur Flour as an "employee-owned, open-book, team-managed company" with 160 current employees. The company has been 100% employee-owned since 2004, and is featured in a Harvard Business School case study, which is listed in the resources listed below.

On the benefits of employee ownership at King Arthur Flour: Our employees really do feel like owners—it's not just empty talk. It manifests itself in the way that, for example, a worker will pull off the highway to write down a great idea so as to share it with his or her colleagues at work on Monday morning. It's the way workers will go the extra mile, the way they approach business and their customers that goes beyond the bare minimum, and beyond what the public expects from a typical business. There's a real sense of employee self-empowerment, of everyone contributing to the success of the company. Employees feel included in decisions. It's a transparent, mutually-respectful arrangement.

On recent media regarding employee stock ownership: It's important to look at the full record on employee ownership and not just what is being picked up by the media. The media focuses on the negative and the dramatic. Diversification is a valid concern, but a skeptic should take an honest look at research and benchmark companies. Research from a Washington State survey shows that ESOP companies provide a higher level of 401k benefit than those that just provide 401k's, so the ESOP is in addition to more standardized benefits. Handled responsibly, concentrated investment can be a good thing--concentration creates wealth and diversification preserves it. Entrepreneurs put their last dime on the line to create huge success. Diverse investments are not a cure-all. An ESOP is a concentration of risk in some ways, but employees do have opportunities to diversify their investments.

On the management lessons King Arthur can offer MBA students: At Harvard Business School, students read and discuss the King Arthur Flour case study and discuss in class the complex relationship between workers and management in a variety of companies. Students know from their own work history that what happens at King Arthur Flour is unique. Good relations between management and workers create an environment primed for success and it makes sense for future managers to consider our extraordinary arrangement.

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NOTABLE COURSEWORK:

The following course descriptions- which all address the topic of employee ownership in some way- are drawn exclusively from the 2007-2008 edition of Beyond Grey Pinstripes, a research survey conducted biennially by the Center for Business Education at the Aspen Institute.

- **Stanford Graduate School of Business**
  Financial Accounting (Core Course)
  Instructors: Ron Kasznik, Ilan Guttman, and Yonca Ertimer
  "This course focuses on the social impact of accounting methods and practices. Much attention is placed on the individual investor's ability to gain accurate information on the financial position of public companies, as well the ways that corporations can meet standards for accurate and ethical reporting. A major course objective is to impart awareness of the judgment involved and the discretion allowed in choosing accounting methods, making estimates, and disclosing information in financial statements. Specific companies studied included Tyco, WorldCom, Enron, Qwest Communications, and other organizations where management's ethics come into question and the financial health of the firm is misrepresented to shareholders. In addition, the Yahoo! Case study analyzes the social impact of stock options, whether companies should be required to expense them, and what impact this policy has on broad employee ownership compared to concentrating options exclusively in packages to senior executives. The course also discusses the social responsibility of corporations to promote widespread economic development and the ability of stock options to achieve this by sharing in the financial success of the corporation. Readings include: 'Cash-Flow Hocus-Pocus,' 'How to Spot Tax Tinkering,' 'Bad for CFOs, Good for Investors,' 'Yahoo, Google, and Internet Math,' 'You Don't Like Our Stock? You Are Off the List,' 'True and Fair Is Not Hard and Fast'."

- **Wake Forest University, Babcock Graduate School of Management**
  Family Business Dynamics (Elective Course)
  Instructor: Stan Mandel
  "This course explores the business, personal and interpersonal issues associated with a family owned and managed company. It examines issues such as an individual's role in a family business; strategic family and business planning; succession planning; family business conflict resolution; and estate

planning. The class explores the impact of the family system on organizational actions, such as philanthropy, employee ownership and owner contributions to others during economic downturns, among others. There are many social issues associated with a multisystem approach to management, and students take away lessons about operating for-profit businesses with a broader focus than strictly on maximizing profits."

- **The Asian Institute of Management**
  Advanced Corporate Finance (Elective Course)
  Instructor: Errol B. Perez
  "Advanced Corporate Finance is designed for MBA Finance Majors. The orientation is quantitative analyses, with capital markets as arbiter of asset values and hurdle rates. The assumption is that participants have had a fairly thorough orientation in the fundamentals. The course objective is principally to sharpen the analytical skills in valuation, capital structure analysis, real options analysis in capital expenditures, and evaluation of financial distress in a reorganization context. Topics include corporate governance, crisis management, dividend policy, employee stock ownership, shareholder relations, liability management, financial policy, risk management, and debt policy."

For additional courses on related subjects, or to download select syllabi, search thousands of descriptions at Beyond Grey Pinstripes.

CASEPLACE.org
Developing Leaders for a Sustainable Society

NOTABLE TEACHING MATERIALS:

Materials referenced are meant to represent the diversity of related teaching resources available at Caseplace.org. Most are available as free downloads to registered faculty members.

- **Case Study:** King Arthur Flour
  Source: Harvard Business School Publishing
  Authors: Thomas DeLong, James Holian, and Joshua Weiss
  "Steve Voigt, the CEO of King Arthur Flour, must determine how the company can continue to grow, whilst preserving its unique culture. In 1996, the company was sold to employees in as ESOP transaction. The following decade saw significant growth, despite declining sales for the industry as a whole. The success could be attributed both to the quality of the product and to the company culture, which treated employee-owners with respect and allowed them to meaningfully contribute to the future direction of the company. By 2006, King Arthur flour had grown from 60 employees to over 200 and Voigt was left questioning whether the unique culture, and ESOP structure, would continue to function as the company continued to expand."

- **Article:** What is an Ownership Culture?
  Source: The National Center for Employee Ownership
  Author: Corey Rosen
  "Our experience and research over the 30 years that employee ownership has shown two distinctive realities: first, overall, employee ownership gives companies a performance advantage-"the ownership edge." Second, there is no ready-to-use process to guarantee that a company will achieve the ownership edge. There are, however, six clusters of practices that appear again and again in successful ownership companies. This article describes these six components of ownership management and illustrates the myriad ways in which companies implement them."

- **Case Study:** Corporate New Ventures at Procter & Gamble
  Source: Harvard Business School Publishing
  Authors: Teresa Amabile and Dean Whitney
  "Consumer products giant Procter & Gamble is faced with an urgent need to revitalize new-product innovation, given its recent focus on incremental product improvements and its aggressive growth goals. As part of this effort, the company's top executives form a small, autonomous, cross-functional Corporate New Ventures team led by a young former brand manager. Operating within a conducive work environment, the team invents a systematic approach to gathering information and producing creative ideas for radically new product categories."

- **Case Study:** United Airlines
  Source: "Rebuilding the Social Contract at Work: Lessons from Leading Cases", Institute for Work and Employment Research, MIT Sloan School of Management
  Author: Thomas A. Kochan
  "In 1994 United Airlines became the largest employee majority-owned enterprise in the United States, with various groups of employees – most represented by unions - having purchased 55% of its stock in exchange for various concessions. The employees accepted pay cuts and made other concessions, but were also granted representation on the company's board of directors. The case represents the potential of an Employee Stock Ownership Plan (ESOP), but not the full realization of that potential. It shows that an ESOP may be a necessary condition but certainly is not a sufficient condition for substantial changes in labor-management relations leading to improvements in company performance." *(This case is one of seven that are examined in the article, 'Rebuilding the Social Contract at Work: Lessons from Leading Cases,' by Thomas Kochan (1999). The article can be found in References on this site. The article contains footnotes and references not included in this version of the case.)*

ONGOING QUESTIONS:

- How can companies apply the management lessons of successful employee ownership models, even if they themselves do not adopt such organization strategies themselves?
- How can corporate-academic relationships and other cross-sector collaborations best mine this area of practice and research?
- How do employee ownership and broad-based stock option strategies contribute to the success of high technology entrepreneurial start ups, and how they continue to play this role as the companies grow and mature?
- What approaches have different companies used in order to place an individual employee's employee ownership within a prudent overall strategy for diversified investment portfolios, and where has it failed?
- In an economy where median inflation-adjusted wages have been relative flat for the last few decades and most real wealth gains have come from capital income (returns on stocks and interests in companies), does employee ownership and broad-based stock options have a role to play or not?

RESOURCES:

BeyondGreyPinstripes.org – World's biggest MBA database, including detailed records on thousands of courses and information on extracurriculars, university centers, and more, for 128 schools on six continents.

CasePlace.org – A free and practical on-line resource for up-to-date case studies, syllabi, and innovative teaching materials on business and sustainability. Created for the educators who will shape our next generation of business leaders!

A Closer Look is a regular series of briefing papers on topical issues in MBA education, based on the research and programs of the Aspen Institute. The Aspen Institute's Center for Business Education encourages future business leaders to innovate at the intersection of corporate profits and social impacts.

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