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Employee Stock Ownership Plans: New Players in the Leveraged Buyout Game

by Jon Shepherd

Hostile takeover. Leveraged buyout. Almost every company chief executive hates to hear those two terms and tries to guard against his or her company becoming the object of an unwanted suitor. Lately, some major companies have been taking steps to protect themselves against possible buyout offers, and one of the most popular defense maneuvers has been to institute employee stock ownership plans (ESOPs). Why did companies originally begin using ESOPs? Will employee stock ownership plans actually protect companies from hostile takeovers? Will ESOPs be used in friendly leveraged buyouts, or will ESOPs be used in hostile takeovers to gain control over the very companies they were originally designed to protect?

Advantages of Employee Stock Ownership Plans

American companies originally began using employee stock ownership plans in order to help motivate their employees. ESOPs improve employees' retirement security by providing stock that employees can purchase while working for the company and sell after retiring. ESOPs also usually make employees more productive and efficient (Hammonds 1989, p. 39). Workers, realizing they will now benefit from increased profits, will tend to work harder at their own jobs and make sure other workers are properly doing theirs. Surveys by the U.S. General Accounting Office and the National Center for Employee Ownership have shown that companies which use ESOPs that involve employee-owners in sharing information and participating in decision-making are more profitable and more efficient than those ESOP companies which do not (Taplin 1988, p. 46). A survey of 400 companies by the ESOP Association found that 71 percent of the respondents believed their ESOP improved productivity (Taplin 1988, p. 85).

The same survey also showed that over one-half of the 400 companies started their ESOPs since 1984 (Taplin 1988, p. 85). In 1989 alone, 70 publicly traded companies established employee stock ownership
plans (Parham 1989, p. 10). Loans to ESOPs skyrocketed from $6.5 billion in 1988 to $18 billion in the first half of 1989 (Parham 1989, p. 10). This huge increase in the use of ESOPs is surely attributable to more than companies merely trying to boost productivity. Employee stock ownership plans also strengthen companies against hostile takeovers. This occurs because, in most tender offers, employees vote their ESOP shares in favor of existing management in order to save their jobs. Even the simple presence of an ESOP may be enough to scare off possible buyers.

The best known example of an employee stock ownership plan blocking a takeover was Shamrock Holdings' attempted takeover of Polaroid, which ended early in 1989. Polaroid permitted its ESOP to enlarge its holdings to 14 percent of the company's outstanding shares in order to stave off Shamrock's bid. Not giving up, Shamrock sued Polaroid in the Delaware court system to block this action. The Delaware Chancery Court judge turned down Shamrock's challenge, ruling that Polaroid's ESOP was completely legal as it was in its planning stages or already partially in place before the hostile bid. The judge also noted that Polaroid's employees could vote their shares in confidence during a tender offer (Hammonds 1989, p. 39). As Malon Wilkus, president of an investment banking firm which specializes in leveraged ESOPs, has said, this court decision "has gone much further than Congress ever would to solve the problem of hostile takeovers" in the U.S. (Hammonds 1989, p. 39).

Polaroid's court victory has inspired many other companies to adopt ESOPs as a takeover defense. The Tribune Company and Lockheed Corporation recently instituted ESOPs to discourage potential purchasers; J.C. Penney borrowed $700 million to buy stock through its ESOP as a defense against a rumored raider; and Proctor and Gamble's ESOP borrowed over one billion dollars, with the company guaranteeing the debt, to purchase enough stock to push its stake to over 20 percent of all outstanding shares (Personnel Administrator 1989, p. 16). Polaroid's employees recently voted to take pay cuts to enlarge their ESOP's holding beyond 14 percent (Hammonds 1989, p. 39). These are just a few of the many companies which began or enlarged their ESOPs after the Polaroid ruling was handed down. Obviously, ESOPs provide some protection from hostile takeovers for those companies that form them.

Leveraged versus Unleveraged ESOPs

When instituting an employee stock ownership plan, a company must decide what benefits it wishes to obtain from the plan. If
protection from a takeover threat is desired, a leveraged ESOP is the correct choice. To create a leveraged ESOP, a company first establishes a trust through which it borrows enough money to purchase the amount of stock needed to reach the ESOP’s planned size. Stock is then generally distributed to employees as the loan is paid off, with the plan’s trustees usually keeping control of the stock before it is distributed (James 1989, p. 55). By assuming a large debt load, the company insulates itself from a takeover because corporate raiders are usually unwilling to attempt to takeover a company with a large debt.

Unleveraged ESOPs are usually established to improve the productivity of employees and/or their retirement security. Under these plans, the trustees purchase shares over time, which means the employer’s contributions of funds for the purchase of stock can be very flexible (James 1989, p. 55). This allows the company to decrease its expenses and contributions in a poor fiscal year and increase them in periods of greater profitability. Because of this flexibility, unleveraged stock ownership plans are the correct choice for companies that have no reason, such as a takeover threat, to purchase a large block of stock at one time.

Employees almost always benefit when a leveraged ESOP is established to prevent a takeover attempt because they retain their jobs while also becoming stockholders. However, leveraged ESOPs almost always hurt existing stockholders because not only are they denied the premium which the raider offers for their shares, but downward pressure is exerted on the value of those shares as the company takes on debt to purchase existing stock or issues new stock. Unleveraged ESOPs, on the other hand, usually impose the burden of payment on the group receiving the benefits of the plan—the employees. Because a large block of stock does not have to be purchased at one time, the company can negotiate with employees to trade wage increases or other benefits for the establishment of an employee stock ownership plan and employer contributions to it.

The Friendly ESOP Buyout

Employee stock ownership plans, created to boost productivity and protect the company from hostile takeovers, are themselves recently being used in more active roles in acquiring companies through leveraged buyouts (LBOs). One of the main reasons for this is the 1984 tax reform law. This law provided opportunities for banks and insurance companies that lend to ESOPs to exclude 50 percent of the resulting interest income from their taxable income (Berss 1989, p. 41).
As a result, they usually offer lower interest rates and payments for an ESOP which borrows to buy company stock than for other borrowers. Secondly, once it purchases the company, the ESOP is allowed to pay the principle and the interest on the debt with pretax dollars (Berss 1989, p. 41). This serves to reduce greatly the company’s tax bill and raises its profits. Some congressional leaders, however, are currently trying to eliminate one of these tax breaks. In June 1989, bills were introduced in the Senate and House to eliminate the tax breaks available to banks that loan to ESOPs (James 1989, p. 55). This would decrease the amount of loanable funds available to ESOPS and would also serve to raise the real cost of loans: the interest rate. Both bills are currently awaiting committee action (Congressional Index 1989, pp. 28,304, 51,103).

There have been several recent examples of leveraged buyouts involving employee stock ownership plans. In 1987 alone, ten leveraged buyouts worth more than $60 million apiece involved ESOPs as the major, if not the only, owner (Employee Benefit Plan Review, July 1989, p. 22). The two largest LBOs involving ESOPs were Avis, whose plan was formed after the company had experienced its sixth owner in five years, and HealthTrust, which became the largest ESOP majority owned company. HealthTrust’s recent history offers a vivid example of the opportunities that may be made available to a company after an ESOP-led acquisition. During the first year of the new ownership the firm experienced savings of over $11 million on supply costs and, at the end of the year, net revenues had increased 8.3 percent (Employee Benefit Plan Review, June 1989, p. 35).

Weirton Steel provides a more sobering example of what can happen when an ESOP decides to buy its own company. In 1984, Weirton’s parent corporation, National Steel, threatened to close the factory because of losses. Weirton’s employees opted to take pay cuts in order to buy the plant and keep it open. Since 1984 the company has been consistently profitable (Berss 1989, p. 42). However, the situation at Weirton has not been as bright as it first seemed. Weirton’s ESOP, like most LBO firms, hired outside managers to run the company, and there have been many conflicts between the employee-owners and their management team. The original ESOP agreement said the company must, in 1990, repurchase all shares held by employees wishing to sell (Schroeder 1989, p. 66). Weirton’s managers, having a limited free cash flow, wished to sell 20 percent of the repurchased shares in a public offering. Not only would this plan save management money, but it would also give it part of the money needed for plant modernization. The other portion of the needed modernization funds would be
realized from a cut in the amount of profits paid to employees from the current level of 50 percent to only 33 percent (Schroeder 1989, p. 66).

Weirton's workers are fighting these moves. They feel that since they were the ones who originally saved the company, they should now reap the benefits of profitability. Also, the employees are fearful of a corporate raider gaining control over a large block of stock and decreasing the degree of worker control over the company (Schroeder 1989, p. 67). This entanglement gives credence to what many critics of ESOP's claim: that employee control, especially when a union is involved, inevitably conflicts with the need for strong management to have free reign to make decisions (Schroeder 1989, p. 66).

**Unions and ESOPs**

Many union leaders do not want to see an ESOP in which their members are shareholders used to purchase a company. Even though the AFL-CIO estimates over 100,000 jobs have been lost in the past five years due to takeovers, many labor union leaders are still not willing to capitalize on the opportunities to increase job security available to them through the encouragement of ESOP-led takeovers (Berss, April 1989, p. 41). More than one-half of the 1.1 million members of the United Food and Commercial Workers Union have seen their employers acquired or merged out of existence, yet their president, Bill Olwell, contends: "I don't necessarily believe we have the capability to run a company" (Berss 1989, p. 41). However, almost all LBO groups hire outside management to run the companies they purchase. Union leaders do not have to know how to run the company in order to participate in an employee-led buyout.

Another reason why unions do not want to encourage ESOPs to participate in leveraged buyouts is put forth by Malon Wilkus, a financial advisor to unions: "Unions are reluctant to do buyouts because they see ESOPs as a tool for union busting" (Berss 1989, p. 41). This is based on the belief that the main purpose of unions is to bargain with the owners for their members. If the employees are the owners, there ceases to be a need for the union, and union leaders find themselves without jobs. Another reason why unions seem to be reluctant to support ESOP-initiated leveraged buyouts is that it requires a radical reversal in the way union leaders think. Unions have almost always prospered on an us-versus-them psychology, but ESOPs turn employees from "us" into "them" (Berss 1989, p. 42). Because of this new "worker capitalism," the adversarial tactics employed by
unions in the past are now becoming obsolete, but union leaders seem to be unable or unwilling to change their way of thinking.

Even when some local union members support an ESOP in its attempt to purchase a company, friction within the union often occurs because national union leaders may wish to avoid participating in worker-led buyouts. In 1988, a hostile takeover of the Stop & Shop retail grocery chain was attempted by the Dart Group. The workers of Stop & Shop, represented by Food Workers Local 1351, attempted to assume the role of white knight and purchase the company. This action almost worked until the national union leaders decided to block the transaction. Stop & Shop was later acquired by Kohlberg, Kravis and Roberts (Berss 1989, p. 41). This seems to be an example of national union leaders being unresponsive to the needs of their members. Whether this occurred simply because the national leaders were afraid of losing their jobs or because they were unable to change their way of thinking is impossible to tell. However, if national union leaders become unresponsive to the needs of their locals, members of the locals may replace them with leaders who might be more responsive to the ESOP options available to them.

According to Berss, one major factor that could cause unions to become more involved in the leveraged buyout game is that some major investment banking firms have a large incentive to get unions involved (Berss 1989, p. 41). This incentive is the huge fee the investment banking firms make from setting up the leveraged buyout plan and from securing the financing actually needed to take a company over. Because of this and the tax breaks to be gained, any ESOP which decides to undertake a leveraged buyout will probably have ready access to the finances and financial advice needed to succeed. This, taken by itself, may be enough to tempt any ESOP into a takeover of its parent company.

Hostile ESOP Buyouts

The previously described involvements in leveraged buyouts by employee stock ownership plans occurred with the blessing of their companies’ managements. However, the first hostile leveraged buyout by an ESOP could be on the horizon. Modine Manufacturing, a major maker of vehicular heat-transfer products, could have the distinction of being the first company taken private by a hostile ESOP-led buyout (Marcial 1989, p. 34). The company’s workers are upset with management because it is not doing enough to raise the company’s stock price. The company’s ESOP, the biggest shareholder, filed a 13D in August
1988, reporting a stake of over 17 percent. A 13D is a document an investor is required to file with the Securities and Exchange Commission whenever a 13 percent or larger stake is acquired in a company. Some experts believe that the ESOP is likely to team up with an outside investor group to take the company private (Marcial 1989, p. 34). Although this has not yet happened, the threat still exists and could be exercised by the ESOP at any time.

Why would Modine’s employee stock ownership plan consider an LBO? Under what conditions might another ESOP undertake a leveraged buyout? To make any leveraged buyout attractive, a company’s stock must be relatively undervalued. In Modine’s case, the stock was selling at around $12, but it had a book value of $14 and a breakup value of over $26 (Marcial 1989, p. 34). Secondly, the stock should be selling at a big discount relative to its competitors’ shares. The price/earnings ratio of Modine’s stock at that time was only 8.3, but its competitors’ P/E ratios ranged from 12 to 15 (Marcial 1989, p. 34). Third, like any other major investor in a company, the ESOP’s members must be kept happy by the company’s management. If management repeatedly ignores the desires of any major investor, including the ESOP, the company may become a takeover candidate.

Another factor increases the possibility of an ESOP-led hostile takeover in the near future. The Internal Revenue Service has recently stated it will now allow investment bankers to sell bonds publicly to finance ESOP stock purchases (Parham 1989, p. 10). Prior to this, employee stock ownership plans, and companies establishing them, could only borrow from private lenders such as banks, insurance firms, and mutual funds. The recent IRS action greatly expands the amount of loanable funds available to ESOPs by allowing them to borrow from many more sources than before. With all the tools now available to employee stock ownership plans, ESOP-led hostile takeovers appear imminent.

**Conclusion**

By the end of 1989, there were over 10,000 employee stock ownership plans in operation, covering almost 10 million employees (James 1989, p. 53). Of the $311 billion in leveraged buyouts in 1989, however, fewer than two percent involved ESOPs (Berss 1989, p. 41). Employee stock ownership plans were originally established because employers believed them to increase the productivity of their workers and because they improved worker retirement security. Companies also began using employee stock ownership plans to protect themselves
from corporate raiders. ESOPs then became active players in the leveraged buyout game by participating in friendly leveraged takeovers. However, employee stock ownership plans have not yet reached their full potential in the leveraged buyout arena. If the government refrains from intervening, employee stock ownership plans can, and will, eventually be a major factor in hostile leveraged buyouts—the very thing they were designed to protect a company from in the first place.

References


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