Center for American Progress

Mitigating Risk to Maximize the Benefits of Employee Ownership

By Karla Walter and Danielle Corley October 2015

Center for American Progress Action Fund

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Introduction and summary

Employee ownership can be a powerful tool to ensure that workers at all levels are able to share in the gains of a company's collective performance. Research shows that employee ownership typically provides a host of benefits—not just for workers but also for businesses and investors. If these programs were to grow throughout the economy, they could promote broad-based wealth creation, thereby fostering sustainable economic growth and reducing inequality.

In today's economy, expansion of these sorts of programs would be particularly helpful to working Americans. Over the past several decades, productivity in the United States has increased, yet the resulting economic gains have largely gone only to those at the very top. Among the top 20 percent of families by net worth, average wealth increased 120 percent between 1983 and 2010, while the middle 20 percent of families saw their wealth increase only 13 percent, and the bottom fifth of families saw their debt exceed their assets.[1] Meanwhile, corporate profits are capturing a growing share of national income.[2] Employee ownership can help reverse this trend by allowing workers to take home a greater share of the wealth that they help create.

Yet policymakers and worker advocates are often slow to embrace these strategies as a means of addressing the challenges facing the economy, and they are also hesitant to advance policies that greatly expand the adoption of these practices. This reluctance is due in part to questions of risk to workers, particularly when employee ownership is a part of a retirement plan.

Indeed, workers do accept an additional measure of risk—with the potential for a larger reward—by participating in employee ownership programs. For the vast majority of workers, however, the benefits of these sharing programs far outweigh the risks. Research shows that adoption of an inclusive capitalism program in a workplace, on average, leads to increased employee participation in decision-making, greater job security and satisfaction—and perhaps most importantly—larger, long-term wealth accumulation and better pay and benefits for workers.[3]

Moreover, companies reap tangible benefits—such as increased productivity, lower turnover rates, and greater survival rates—and investors benefit from better overall performance.[4]

Despite these findings, policymakers and worker advocates often question whether the risk of company failure—which would cause workers to lose their jobs and potentially a portion of their retirement savings—outweighs all of the positive benefits that occur when employee ownership is part of retirement. The most common forms of employee ownership as part of retirement are employee stock ownership plans, or ESOPs, and 401(k) plans that include company stock.

Headline-grabbing tales of company stock ownership gone awry at firms such as Enron, United Airlines, and The Tribune Publishing Company, which publishes the *Chicago Tribune*, the *Los Angeles Times,* and other media outlets—have furthered the fear that such programs saddle workers with more risk than the retirement benefits are worth.

This report has two goals. The first goal is to answer questions about undue risk in order to prevent companies from adopting employee ownership structures that endanger workers and jeopardize the collective benefits of broad-based sharing. The second goal is to help create widespread support for policies that would encourage greater adoption of beneficial employee ownership and other sorts of broad-based profit-sharing programs throughout the economy.

The report reviews existing research on risk for workers participating in ESOPs or investing in company stock through a 401(k) plan and finds that the vast majority of workers who are participating in these programs are not exposed to undue risk.

The report also features analysis of the high-profile failures of Enron, United Airlines, and the Tribune Publishing Company—both in terms of the effect of an employee ownership structure on company failure and the ensuing effect on workers.

Building on existing research and the lessons from these cases, this report offers the following policy solutions to mitigate risk while still allowing workers to benefit from inclusive capitalism:

- First, the federal government should limit 401(k) investment in company stock to 15 percent of total holdings. This would protect workers who are invested heavily in their employer's stock, either by their own choosing or as a result of matching contributions from the company.

- Second, the federal government should allow early diversification for workers who are participating in an ESOP that requires wage and benefit concessions or when the employer does not contribute to another retirement vehicle, such as a 401(k). ESOP companies rarely require wage and benefit concessions, and they are far more likely to offer another retirement plan than comparable companies without an ESOP. Yet in companies that do require concessions or do not contribute to another retirement vehicle, company failure would have a much greater adverse effect on workers.

- Third, the federal government should strengthen its oversight to ensure that companies correctly value stock that is being sold to workers. The government can do this by requiring companies to adopt valuation best practices at the outset of a company sale and better targeting the riskiest ESOP sales for audit by the U.S. Department of Labor, or DOL.

These policies will not affect the vast majority of companies that have employee ownership and that are already acting in employees' interests. In fact, policies such as better targeting of DOL audits hold the promise of reducing burdens for employee-owned companies with few risk factors. Rather, they are targeted to address the minority of companies with employee ownership where workers face undue risk. In sum, this report aims to start a dialogue about how to better protect workers while still offering the benefits of inclusive capitalism.

In July 2015, the Center for American Progress released the report "Capitalism for Everyone," which details policies that encourage greater employee ownership and broad-based profit sharing throughout the economy.[5] That report should be read as a companion to this report, and the policies outlined in "Capitalism for Everyone" should be adopted in conjunction with the policies profiled in this report.

Employee stock ownership plans vs. 401(k) plans with company stock

The most common forms of employee ownership as part of retirement packages are employee stock ownership plans and 401(k) programs that include company stock. There is, however, a significant difference between the two. ESOPs were conceived as a way for workers to share company ownership, and in most cases, all of the ESOP contributions come from the company.[6] Company 401(k) plans were originally designed as additional retirement plans to supplement defined benefit plans, and a significant proportion of 401(k) contributions generally come from the employee.[7] The increased reliance on 401(k) plans as the primary source of retirement security for most workers developed later, complicating the use of company stock in these plans.[8]

ESOPs are tax-qualified benefit plans that provide workers a share in the company without having to spend their own money to buy the stock themselves. Instead, the employer establishes a trust and contributes new stock or cash to buy existing stock—typically amounting to 6 percent to 10 percent of the employee's salary.[9] The company may borrow money to do this, making it a leveraged ESOP. Shares of the trust are distributed to individual employee accounts. When employees retire or leave the company, the employer must buy back the stock in their individual accounts at its fair market value unless it is available for public sale.[10]

401(k) plans with ownership of company stock are employer-sponsored retirement savings plans that allow workers to put aside part of their paychecks for retirement before taxes are taken out. Workers can choose to invest their money in a mixture of stocks, bonds, and mutual funds.[11] Employers then typically match employee contributions up to a certain level.[12] The average employer-promised match is 4.2 percent of pay, and the median match is 3 percent of pay.[13] In some instances, company stock is offered as an investment option or is the form of employer contribution. Overconcentration occurs when an employee has a 401(k) invested heavily in the employer's stock, either by his or her own choosing or as a result of matching contributions from the company. Experts generally recommend that no more than 10 percent to 15 percent of a worker's portfolio be invested in company stock.[14]

How much risk is too much risk?

Inclusive capitalism programs require workers to accept some of the risk of poor company performance if they are also to share in the wealth if the company succeeds. Proponents of inclusive capitalism argue that companies benefit from these sorts of sharing programs because employees are more invested in the company's well-being and will work harder to ensure success. Critics point out, however, that by tying wages and retirement to the same company, workers lose both their income and investments if the company fails.

Excessive risk is not only a threat to workers but also participating companies. Research has shown that excessive risk can reverse the positive workplace benefits of shared capitalism.[15] If workers feel economically insecure based on their income and the value of their capital safety nets relative to their incomes, they have more negative attitudes toward inclusive capitalism; less preference to participate in inclusive capitalism; and lower levels of motivation, job satisfaction, and company attachment and loyalty.[16]

Some risk, however, is inherent in shared ownership. So when is there too much risk? Research generally shows that risk is limited in both employee stock ownership plans and 401(k) plans, but there are certain factors that can increase risk. While there is some risk in any situation where compensation is variable based on company performance, risk level varies by type of program. Substituting wages or retirement savings for company stock makes workers far more vulnerable than granting workers stock ownership in addition to adequate pay and benefits. Not providing another retirement vehicle or limiting participants' ability to diversify also puts workers at additional risk. Deeper exploration of these risk areas in each program will impart a better understanding of how best to mitigate them.

Employee stock ownership plans

Research shows that companies with ESOPs offer shared ownership in addition to fair wages and retirement benefits. Several studies have found that for workers in employee-owned companies, pay and benefits are equal to or better than those of workers in comparable companies that are not employee owned.[17] Additional research shows that wages are higher within companies after they have instituted employee ownership programs—showing that these programs do not act as a substitute for good wages.[18] On average, ESOP companies contribute 75 percent more to their employee stock plans than other companies contribute to their primary defined contribution plan.[19] Companies with employee ownership are also more likely to offer defined benefit plans or to offer a second defined contribution plan other than similar non-ESOP companies are to offer one at all.[20] Furthermore, ESOP companies, on average, are more stable and have higher rates of returns than the average company 401(k) plan. According to research by the National Center for Employee Ownership that included 20 years of data, ESOPs were less volatile and had higher rates of return than 401(k) plans in 15 of the 20 years. The average rate of return over the time period was 7.8 percent for 401(k) plans and 9.1 percent for ESOPs.[21]

ESOPs also have lower average default rates and better survival rates than comparison companies. In a study of 1,232 leveraged ESOP transactions at three banks between 2009 and 2013, ESOP companies had an average annual default rate of 0.2 percent. In comparison, the annual default rate for all midmarket companies that were borrowing less than $200 million was 3.75 percent per year from 2010 to 2013.[22] Another study that looked at company survival rates in privately held ESOP companies and comparable firms found that the ESOP companies were only half as likely as non-ESOP companies to go bankrupt or close over a 10-year period and only three-fifths as likely to disappear for any reason.[23]

While all evidence points to the fact that the majority of companies with ESOPs are adopting best practices that largely mitigate undue risk to workers, government policies do not wholly prevent against exposing workers to high-risk ESOPs.

For example, although ESOP companies are more likely to provide a 401(k) plan or defined benefit plan than comparable companies, they are not required to do so. And even when a company's only retirement vehicle is an ESOP, workers have no ability to diversify their account holding until age 55.[24] If the company is not performing well, and the employee does not meet the requirements for diversification, they may be unable to protect themselves from suffering loss.

Additionally, in recent years, the federal government has been increasingly focused on enforcing fair value stock prices during the sale of a company to employees. If a company is not publicly traded and wants to establish an ESOP, its stock price must be determined by an ESOP trustee, who relies on the judgment of a valuation advisor. While best practices are generally agreed upon throughout the valuation community, there is no formal regulatory guidance in place to ensure that all companies adhere to them.

Owners who are looking to exit a struggling company may seek out an appraiser who is willing to recommend a purchase price that is inflated higher than what the market would reasonably bear if the company were sold to an outside owner. In this scenario, workers may not just be purchasing a poorly performing company for more than its fair market value. Because the stock price was overvalued at the point of sale, retiring employees will also make less when they sell the stock back to the company, and the company will have more difficulty repurchasing it.

The Department of Labor found that when ESOPs do violate the Employee Retirement Income Security Act of 1974, or ERISA, incorrect valuations are one of the most common forms, and the department has increased scrutiny in this area.[25] Since 2010, the agency has recovered more than $241 million from ESOP cases, mainly involving valuation.[26] While this is only a small fraction of the total ESOP plan assets, DOL is charged with auditing companies with ESOPs in order to ensure that employees are not overpaying for company stock.[27] In this process, there is no formal regulatory guidance on how valuations must occur.

401(k) investment in company stock

High-profile company failures in the early 2000s, including those of Enron and WorldCom, demonstrated the potential dangers of workers using their 401(k) plans to invest heavily in company stock. In these instances, employers encouraged workers to buy company stock in their 401(k) plans by offering generous matching programs and limiting diversification. While Congress enacted legislation in the wake of these failures in order to encourage workers to diversify their retirement holdings, there is evidence that a small but significant minority of workers continue to rely too heavily on company stock in their 401(k) plans. And unlike ESOPs—which are most frequently an addition to another employer-sponsored retirement plan and funded entirely through employer contributions—401(k) plans are often the only retirement vehicle offered by an employer and involve a large share of worker contributions.

Indeed, Enron and WorldCom were not outliers but instead extreme examples of a larger trend of publicly traded companies that used employer stock as a match for worker contributions.[28] After the collapse of Enron, regulation and attitudes toward employee investment in company stock began to change. The Pension Protection Act of 2006 required employers who offered defined contribution plans with publicly traded securities to provide employees with the opportunity to divest company stock after three years of service for employer-contributed stock and immediately if the employee purchased the stock.[29] Also, companies started to limit company stock matching programs, and employees began to make fewer investments in company stock on their own.[30]

Today, a small but significant minority of workers are heavily invested in company stock. Joseph R. Blasi and Douglas L. Kruse of the Rutgers University School of Management and Labor Relations and Harry Markowitz of the University of California, San Diego, Rady School of Management found that the optimal share of company stock in a worker's portfolio should be 8.33 percent, while a range of 10 percent to 15 percent would have a small effect on the portfolio's volatility.[31] With this level of investment, the remainder of an employee's assets can then be diversified among other investments. This finding is particularly important because it comes from Markowitz, winner of the Nobel Prize for modern portfolio theory.[32] Portfolio theory advocates for proper diversification in order to mitigate risk; therefore, Markowitz's conclusion that employees can have some investment in company stock is significant.[33]

Yet the 2010 study by Blasi, Kruse, and Markowitz found that nearly 16 percent of participants had more than 28 percent—or twice the average—of their net wealth in company stock, while about 5 percent had more than half of their net wealth in company stock.[34] Another study by the Employee Benefit Research Institute and the Investment Company Institute found that new 401(k) participants were less likely to hold high concentrations of company stock after the Enron scandal, but that some employees still heavily invested. In 2001, nearly 23 percent of new 401(k) participants held more than 50 percent of their account balance in company stock. In 2013, the figure had dropped to nearly 10 percent of new 401(k) participants holding more than 50 percent in company stock.[35]

Many employees do not diversify even when given the chance. Studies show that efforts to educate workers about the harm of high concentrations of company stock or to empower workers through diversification options have a limited effect on actual employee investment choices.[36] In an overarching study on the relationship between financial literacy and financial education to financial behaviors, Daniel Fernandes of the Catholic University of Portugal, John G. Lynch Jr. of the University of Colorado-Boulder Leeds School of Business, and Richard G. Netemeyer of the University of Virginia McIntire School of Commerce, reviewed 168 papers that covered 201 prior studies to find that financial education interventions had virtually no impact on the investment behavior of participants.[37]

A related study looked at the influence of media coverage of major company failures where employees had 401(k) plans loaded with company stock. The results show that the plethora of news stories on companies including Enron, WorldCom, and Global Crossing had little effect on employee investment in company stock—at most, 2 percentage points. The same study also looked at the impact of employees gaining the ability to diversify their company stock holdings either by reaching a certain age or through loosened restrictions on all employees. Although they had opportunities to diversify, most employees at these companies continued to hold 80 percent to 90 percent of their employer match balances in company stock.[38]

Company case studies: Did employee ownership go wrong?

When large companies with employee ownership fail, media coverage naturally gravitates to the question of whether the ownership structure was to blame and how the employee-owners were affected. Enron, United Airlines, and Tribune Publishing Company all gained national attention not only for their large-scale bankruptcies but also for corporate practices that cost workers their jobs and a portion of their retirement savings when the companies collapsed.

Critics touted these cases as evidence that employee ownership is unsustainable and leads to company failure. In general, however, these companies did not represent typical employee ownership conditions. Amid financial troubles, employers put workers at additional risk by either forcing wage and benefit concessions, failing to provide an additional retirement vehicle, neglecting to create a collaborative ownership culture, or some combination of all three. Given these circumstances, it is unfair to place all blame on the companies' employee-owned structure.

Still, evaluations of these cases offer important lessons for how federal government policy can impose stronger monitoring and limitations on companies with these less common structures that can put workers at undue risk.

First, overinvestment of 401(k) plans in company stock can lead to devastating results. While investing a portion of an employee's retirement portfolio in company stock allows workers to share in the capital gains of the employer, overinvestment puts workers at risk of losing salary and retirement savings in the event of a company downturn or failure. Even worse, the investment in company stock also often comes from the worker's own pocket.[39]

Second, there are certain employee stock ownership plan design features that put workers at additional risk. Requiring employees to give up salary or benefits in order to participate in the plan or failing to provide an additional retirement vehicle leaves workers vulnerable in the event of company failure. Employee ownership models should be a supplementary benefit to existing wages, benefits, and retirement plans, rather than a substitution.

Finally, the valuation of the stock sold to the ESOP must be done in a way that is fair and with workers' interests in mind. If not, the entire deal may be based on the false promise of future value that workers will not actually receive. Establishing the plan in a way that is honest and fair to workers is critical for success.

Enron

Before its demise, Enron was renowned as a global energy powerhouse and named by *Fortune* magazine as the most innovative American company for six years running.[40] This reputation quickly unraveled as it was revealed that the company's success was built on years of extensive accounting fraud orchestrated by senior executives to inflate stock prices and thereby make themselves rich.[41] Employees—whose 401(k) plans were deeply invested in company stock—lost everything when the company failed. Their jobs were gone, and their retirement accounts were left valueless.

Enron declared bankruptcy as the details of the company's fraud became public in late 2001. Some experts and commentators speculate that a major factor behind the executive corruption was the overemphasis on stock options for their compensation.[42] But it was not just the top executives who held stake in Enron's stock. Most company employees also held the bulk of their retirement savings in company stock. Workers could contribute as much as 15 percent of their salaries to a 401(k) plan, and Enron would match half of the contributions in company stock, up to a limit of 6 percent of the employee's base pay.[43]

Employer-contributed shares had to be held until employees reached age 50, at which time they could sell or diversify.[44] While workers had a menu of options for their own 401(k) contributions, the company's top executives encouraged lower-level employees to invest in company stock—even as the company was floundering and the executives themselves were rapidly selling their shares.[45] This practice allowed the company to compensate workers with a noncash currency—which was far less valuable than perceived—and to receive the tax benefits of shared ownership.[46]

As the company's accounting fraud came to light in the fall of 2001, the value of Enron's stock quickly plummeted.[47] Meanwhile, management halted workers' ability to sell their shares.[48] When the company declared bankruptcy in December 2001, Enron stock—once worth a peak of around $90 per share—was down to just 36 cents per share.[49] Of Enron's 21,000 employees, more than 4,000 were laid off, and the roughly 12,000 with 401(k) plans heavily invested in company stock lost the bulk of their retirement savings.[50] For example, an executive assistant who lost her $49,000 salary also lost stock that was once worth $150,000.[51]

In total, workers lost a collective $2 billion in retirement funds, on top of salary losses.[52] Sixty-two percent of the company's entire 401(k) plan was invested in Enron stock at the end of 2000.[53] Enron estimated that employees purchased 89 percent of this stock, and the remainder was purchased through the company's contributions.[54]

Since the Enron scandal, legislative reforms have been enacted to regulate the use of employee stock ownership as a retirement vehicle. For example, the Pension Protection Act of 2006 allows employees at publicly traded companies to diversify their own holdings of company stock at any time and to sell employer-contributed stock within three years of receipt.[55] It also requires companies to notify employees of their diversification rights.[56] The Sarbanes-Oxley Act of 2002 requires companies to inform plan participants at least 30 days in advance of a blackout period, such as the one instituted by Enron in fall 2001.[57]

Employers have also changed their retirement plan designs to provide fewer company stock investment options. One study found that between December 2005 and June 2011, roughly one-third of company stock funds stopped allowing new money or were eliminated from retirement plans completely.[58] Still, these reforms did not go so far as to broadly limit the level of investment in company stock, and a small but significant minority of workers remain overinvested in their companies.[59]

Policymakers have proposed additional reform measures that would have limited the total amount of company stock allowable in 401(k) plans—either of employee contributions, employer contributions, or both.[60] Others would have allowed 401(k) plans to either have employee contributions in company stock or employer contributions in company stock—but not both.[61]

United Airlines

Employees purchased United Airlines in 1994 to rescue the company from financial crisis, which was in part caused by new competition from low-fare airlines.[62] Unionized workers drove the transition to an ESOP—and accepted wage concessions to do so—but an industrywide downturn, as well as ongoing problems with management and declining support from workers, ultimately led the company back into bankruptcy. When United eventually emerged from bankruptcy, workers had lost a significant portion of their retirement savings when the ESOP shares lost their value.

United's pilots and their union—the Air Line Pilots Association—originally proposed the idea of an ESOP in the late 1980s. When the company fell into crisis in 1993, the pilots brought back the idea as a way to restructure concessionary labor contracts—this time with support from the machinists union. While the union members had the opportunity to vote on the deal, nonunion members did not.[63]

The United ESOP was not designed in a typical fashion. Instead of offering a benefit above and beyond competitive wages, the deal required participating employees to make significant wage, benefit, and work-rule concessions in exchange for a $4.9 billion loan to buy a 55 percent ownership stake through an ESOP.[64] Pilots and machinists took 12 percent to 15 percent cuts in pay, and nonunion employees took 8.25 percent cuts in pay.[65] Additionally, the ESOP was conceived as a temporary fix; original wages were to be restored when the ESOP agreement expired in 2000.[66] Notably, unionized flight attendants withdrew from the deal before it was finalized, due to outstanding issues with management and to avoid large wage concessions that they felt they could not afford.[67]

The United ESOP transition initially appeared to be a success. The first year under the ESOP was the best year for shareholders in the company's history: The company increased in value by more than $4 billion. Revenue per employee went up 10 percent.[68] Employee relations also seemed to improve: Grievances fell 74 percent, and productivity increased while absenteeism declined.[69] Management incorporated employees into company governance, with 3 of the 12 board positions going to employee representatives.[70] So-called best of business teams organized employees across different departments to discuss worker concerns and find ways to make efficiency improvements and cut costs.[71]

However, this collaborative environment did not last long. After just more than a year, United brought in new leadership, and many of the ESOP's original advocates were replaced by those who were less supportive.[72] The best of business teams were disbanded, and as overall efforts to involve employees in corporate governance declined, pre-existing and long-standing negative relations between labor and management resurfaced.[73]

The structure of the ESOP also presented divisions among workers. As noted earlier, flight attendants—who comprised one of the largest employee unions and were arguably the face of the company—never joined the ESOP.[74] In addition, United's ESOP was set up to offer employer contributions until only 2000, meaning that employees who joined the company after that date could not participate.[75] With so many employees shut out of the ESOP, union leaders increasingly represented employees with no stake in company ownership.[76]

The tumultuous labor-management relationship, competition from low-fare airlines, and the downturn in the airline industry after September 11, 2001, were too much for the company to handle. By 2002, United declared bankruptcy. Workers who were part of the ESOP lost their stock value, along with the wage concessions that they had made in order to establish the plan. The typical mechanic, for example, had given up $80,000 in wages for stock that dropped significantly in value after the bankruptcy.[77] Employees also later suffered losses to their retirement funds when the company defaulted on its $9 billion pension obligations. In total, employees lost $3.3 billion, or two-thirds of what had been invested in the ESOP.[78]

United's failure was touted by some as evidence of the shortcomings of employee ownership, but it was not a typical ESOP in many ways. Employees were forced to give up wages and benefits in order to save a failing company—which is the case in only a handful of companies each year.[79] Efforts to develop a culture of ownership were short-lived. Moreover, the ESOP's expiration date and the failure to incorporate all workers created a chasm between employee-owners and nonowners.[80] Experts recommend that, in this concessionary environment, management should have paired the ESOP with a short-term profit sharing plan in return.[81]

A poor economy and competition from low-fare airlines also contributed significantly to United's decline. The entire airline industry suffered from this situation, which was then worsened by the 9/11 terrorist attacks and subsequent decline in air travel.[82] Other airlines suffered also suffered at that time: Northwest Airlines and US Airways declared bankruptcy, and American Airlines nearly did so.[83] The combination of external economic and industry factors, along with poor ESOP design and implementation, led to United's failure.

Tribune Publishing Company

When real estate billionaire Sam Zell acquired Tribune Publishing Company in April 2007, media and business insiders questioned whether the tycoon could save the faltering company. Zell acquired Tribune through a series of complicated financial maneuvers that included establishing an ESOP as a means of leveraging enough debt to make the deal happen. Passing benefits on to workers or creating a culture of employee ownership was never a goal of the ESOP. Instead, the deal used ESOPs in a way that they were never intended to be used—and eventually ruled illegal. While Zell's attempt to rescue the company failed, Tribune Publishing Company employees emerged from the transfer of ownership relatively unscathed.

When the company's board agreed to let the current executive team collaborate with Zell in order to develop a plan, Tribune Publishing Company had been on the market for several months without a viable bidder who was willing to take on the debt that was required to appease shareholders.[84]

Zell's buyout occurred in a complicated procedure and involved the company taking on massive amounts of debt. First, Zell invested $250 million of his own money in the company, and the ESOP borrowed money from the company in order to buy $250 million in shares at $28 per share. Tribune then borrowed enough money to redeem the remaining shares at $34 per share. Zell made an additional $90 million investment to purchase the right to buy a 15-year warrant that allowed him to buy as much as 40 percent of the company if he paid another $500 million. The result was a 100 percent S corporation ESOP, with Zell owning the right to claim up to 40 percent of the company's value.[85] As an S corporation ESOP, Tribune would not pay federal income taxes.[86] Instead, ESOP members would pay income tax on the share of stock they received upon leaving the company.[87]

Tribune emerged from the massive deal with more than $13 billion in debt.[88] This came at a time when the newspaper industry was in a major downturn. Tribune stock had fallen 36.4 percent over the previous three years, and the industry was rapidly losing revenue as advertisers moved to online media.[89] The financial crisis was also looming, and more than 40 percent of the company's revenue came from media outlets in California and Florida—two states heavily hit by the housing market crash.[90]

Despite Zell's initial promise that there would be no layoffs, more than 5,000 people lost their jobs or were bought out as the company dealt with its massive debt and declining newspaper circulation.[91] At the same time, managers were receiving bonuses and company radio stations were offering outlandish cash giveaways.[92]

Additionally, the turnover in leadership brought an unproductive change in company culture. Instead of fostering an ownership culture—which research shows is important to the success of ESOPs—the new management team created an unprofessional environment that made many employees uncomfortable.[93] Many workers became disillusioned, and efforts to spur employee innovation were ill received.[94]

This combination of immense debt, poor industrywide performance, a weak economy, and bad management was too much for the struggling company. By December 2008, Tribune filed for bankruptcy. In 2010, Zell's chosen CEO resigned amid charges of creating a hostile and sexist work environment.[95] Zell resigned as chairman in late 2012 when the company emerged from bankruptcy and returned to a C corporation status under new ownership.[96]

Several former employees filed a federal lawsuit against Tribune, Zell, and GreatBanc Trust Company, which served as the ESOP's trustee. The courts agreed with the employees' claims that GreatBanc violated its fiduciary duty by allowing the ESOP to pay more than the fair market value of the stock.[97] These charges were later dismissed for Tribune and Zell.[98] The settlement in 2012 restored $32 million to ESOP participants.[99] Some experts and commentators have suggested that the sale to employees—and consequently the entire deal that created an ESOP— would not have happened if there had been a better upfront valuation of the company.[100]

A federal district court also ruled that the entire transaction that occurred when Zell sold the Tribune to the ESOP was prohibited because workers received unregistered stock—meaning that employees could not sell it publicly—while there were still shares being publicly traded.[101] The Employee Retirement Income Security Act of 1974 requires that the stock ESOPs purchase be available on the public market or—if the company is privately held—the class of stock with the highest combination of voting and dividend rights.[102]

Although the Tribune Publishing Company deal was rife with abuse and legal violations and ultimately did not save the company from having to employ large-scale layoffs, workers did not experience major losses to their retirement savings.[103] Before the buyout, Tribune matched the first 4 percent of worker contributions to 401(k) plans. Employees also could get as much as an additional 5 percent of their pay as a variable contribution depending on corporate profits. After the sale to the ESOP, the company contributed an amount equal to 5 percent of pay to the ESOP. Existing employee retirement funds were not converted to the ESOP when it was founded. Workers also received a 3 percent match into another employer-sponsored retirement plan, which was not subject to bankruptcy claims because the Pension Benefit Guaranty Corporation insured it.[104]

The bankruptcy rendered the company stock worthless for the 10,000 participating employees.[105] However, the short life span of the ESOP limited the amount of money that had accrued for workers and thus could have been lost.[106] Moreover, during that period, employees were still accruing an employer match of as much as 3 percent in their secondary retirement plan.[107] The employees who were most affected by Tribune's bankruptcy were those who recently had been promised deferred compensation or had accepted a buyout package and were still owed severance at the time of bankruptcy because Tribune Publishing Company said it would stop making these payments.[108]

Tribune Publishing Company's transition to an ESOP company was more of a financial maneuver than an effort to promote employee ownership. By taking on this structure, Tribune was able to avoid millions of dollars in taxes—for example, it avoided $348 million in 2006 alone.[109] The ESOP was manipulated to save a troubled company, and in the process, employees paid more for the company than what it was worth.

Policies to mitigate undue risk

Research demonstrates that companies such as Enron, United Airlines, and Tribune Publishing Company created atypical structures for their employee stock ownership plans that threatened employees with an extraordinary amount of risk. The vast majority of companies that provide employee ownership through retirement do so without exposing their employees to undue risk. For example, almost all ESOPs are funded strictly through employer contributions and, on average, provide advantages above and beyond decent pay and benefits. Additionally, ESOP companies actively address risk in a number of ways, including insurance programs, protection trusts, and routine repurchase obligation planning.[110] Moreover, most workers' holdings of company stock in 401(k) plans are at levels that do not jeopardize their future retirement savings.

For this reason, the policies recommended below are targeted to address the minority of companies where workers face undue risk through employee ownership; these policies are not intended to affect employee-owned companies that are already acting in workers' interests.

These solutions focus on targeting the risks identified in the previous sections, including overconcentration of 401(k) plan assets in company stock; companies that require wage and benefit concessions or where the ESOP functions as the only employer-sponsored retirement plan; and companies that sell overvalued ESOP stock to workers.

To help alleviate these risks, policymakers should limit 401(k) investment in company stock; allow early ESOP diversification for companies that require concessions or do not offer another retirement vehicle; and enact safeguards and enforcement mechanisms to ensure that companies correctly value ESOP stock.

The authors hope that these concepts spark a dialogue about how to better protect workers while still offering the benefits of inclusive capitalism. By tackling these issues head on, policymakers and advocates who previously have been hesitant to embrace these programs will be more likely to support policies that incentivize employee ownership in the future.

Limit 401(k) investment in employer stock

Despite policies to ensure that workers are able to diversify 401(k) plan assets out of employer stock, a small but significant percentage of employees remain invested heavily in their company's assets. Moreover, research shows that workers who receive employer contributions in the form of company stock are likely to retain it in this form rather than reinvest in other types of assets.[111]

In 2010, nearly 16 percent of workers had more than 28 percent of their net wealth held in company stock, while nearly 5 percent had more than 50 percent in company stock and 0.6 percent of workers had 100 percent of their net wealth in company stock.[112] Additionally, research by The Vanguard Group found that an employee's probability of holding a concentrated position of company stock—or more than 20 percent—more than doubles when the 401(k) plan directs employer contributions to company stock.[113] These workers face the risk of losing the bulk of their retirement savings in the event of company failure or significant depreciation in stock.

To address this issue, we propose limiting the total portion of employer stock in 401(k) plan assets to 15 percent.[114] Participants whose funds reach the 15 percent limit will be notified that any additional investment earmarked for employer stock will be automatically enrolled in a diversified fund, unless the employee elects to opt out. Diversified funds, such as index funds or target-date funds, alter their investment mix over time to meet the needs of the employee's desired retirement date and are rapidly becoming the dominant investment strategy when workers' 401(k) plans are automatically invested.[115]

Researchers and investment experts generally recommend that the portion of 401(k) assets invested in company stock not exceed 10 percent to 15 percent of all investments.[116] Similarly, ERISA limits the amount of company stock to 10 percent in defined benefit plans, which were the primary employer-sponsored retirement benefit plan at the time of the law's passage.[117] Yet there is no limit on the amount of company stock that defined contribution plans—such as 401(k) plans—may hold.[118]

By limiting company stock in 401(k) investments, workers would be protected from severe loss to their savings in the event of a company failure or drop in stock price. These protections could have spared workers some of the devastating effects in the fall of Enron and can ensure that even in less dire situations, workers are not entirely reliant upon company stock for their 401(k) retirement security.

Allow early diversification in higher-risk ESOPs

While most ESOPs are funded by the company and offer a secondary retirement plan, exceptions to these norms can make ESOPs riskier for workers. If a company requires workers to make wage concessions in order to participate in the ESOP or does not contribute to a second retirement plan, workers are put at greater risk of loss in the event of company failure.

These higher-risk ESOPs are rare. Only a handful of companies annually require employees to use wages concessions to fund an ESOP. Moreover, ESOP companies are far more likely to offer another employer-sponsored retirement plan than similar non-ESOP companies are to offer one at all. Yet workers in these situations have no ability to diversify their account holdings until they near retirement. When these circumstances exist, workers should have more of a say in the investment of their savings. Employees in such cases should have early diversification options.

Current diversification rules allow ESOP participants who have participated in the plan for 10 years and reached age 55 to diversify as much as 25 percent of their stock over the next five years. Workers can then diversify as much as a total of 50 percent of stock, minus any previously diversified shares, in the sixth year. The company must offer at least three alternative investment options under the ESOP or another retirement plan, or else issue cash or company stock to the participants.[119]

The current rules meet the needs of most workers in ESOP companies. However, the two situations described above expose workers to added risk and call for earlier diversification. The federal government should therefore require companies to institute early diversification if workers who make wage concessions participate in the ESOP or if the employer does not contribute to another retirement plan, such as a 401(k). The required contribution level for another retirement vehicle should be set at 2 percent of salary. This is less than the current median matching contribution for 401(k) plans, to account for the fact that ESOPs generally contribute an amount of 6 percent to 10 percent of an employee's salary to employee accounts.[120]

Companies with wage concessions or without a secondary retirement plan would automatically diversify 25 percent of employee ESOP accounts after 10 years, unless employees opted out. Then, five years after initial diversification, another 25 percent of the participants' accounts would be diversified. Participants would receive their shares as a direct rollover into an individual retirement account, or IRA, or other qualified retirement plan.[121] Upon establishment of a concessionary plan or plan at a company with no other retirement vehicle, workers would be notified of the risks that are involved with overinvestment in the company and the automatic early diversification schedule.

Early diversification would give workers the positive benefits of employee ownership while better protecting them with diversified investments.

Ensure that companies correctly value the stock that they sell to workers

If a company is not publicly traded and wants to establish an ESOP, its stock price must be determined by the fiduciary, in consultation with a valuation advisor. The sale must be for adequate consideration, or for the fair market value of the stock as determined in good faith by the trustee.[122] While best practices in private stock valuation are generally agreed upon throughout the ESOP community, there are not formalized standards for valuation.[123] As a result, there may be cases where workers' best interests are not served in this process. For example, an owner looking to exit a company may seek out a valuator who is willing to inflate the purchase price over what the market would reasonably bear if the company were sold to an outside buyer. Or the person who is selling the company to the ESOP could also be the one setting the price of the stock.[124] And although research shows that two-thirds of ESOP companies are confident that their appraisers assessed the repurchase obligation in determining company value, too often the valuator and/or trustee does not actually take this into consideration.[125]

In recent years, the federal government has focused increasingly on enforcing overinflated stock prices during the sale of a company to employees. However, there is insufficient regulatory guidance for the ESOP stock valuation process, and the way the government identifies companies at risk for improper valuations does not take into account a number of risk factors.

The federal government should establish regulations that guide the valuation process and better enforce the law by targeting the companies most at risk for overinflating stock prices.

A recent settlement between the Department of Labor and valuation company GreatBanc Trust Company provides detailed best practices for stock valuation. DOL has publicly stated that other companies should follow these as guidelines, but there are no regulatory or legal requirements that they do so.[126]

In addition, DOL is working with experts within the ESOP valuation community to develop new regulations for determining adequate consideration.[127] These regulations would provide much-needed guidance on how valuations should be conducted and what sorts of safeguards the government will expect companies to adopt.

DOL should continue to prioritize the enactment of these regulations with continued involvement of the ESOP community. Moreover, the final rule should include guidelines to prevent valuator conflict of interest, outline a process for the fiduciary to understand and review the appraiser's work, and identify items to take into account in the valuation, including repurchase obligation. In the case of Tribune Publishing Company, instituting these upfront requirements could have helped restructure the deal—or even prevented the deal—as valuation advisors considered how the company would be able to meet its repurchase obligations while also servicing the incredible amount of debt that Sam Zell brought upon the company.

The federal government also should institute better targeting and enforcement of companies that may have overinflated stock prices. Currently, DOL uses an annual reporting form—the Form 5500 Series—to target companies. The form allows the agency to identify companies that have experienced a dramatic change in valuation or have a valuation that is higher than industry standards.[128] DOL should continue to target companies that have experienced dramatic changes in stock price, especially in the first few years after a transaction, or that have stock values higher than industry standards.[129] The department also should consider how to amend the questions on the 5500 form to allow the agency to target ESOPs that may be riskier to workers. For example, there could be questions that identify ESOPs that were established only after workers made wage or salary concessions, plans that lack sufficient cash assets to buy out retiring employees, or ESOP transactions that involved the 100 percent sale of the company.[130]

When an ESOP plan lacks sufficient cash assets, it may signal that the plan is representing the company as more stable and valuable than it really is or that it may be unable to fulfill repurchase obligations when workers retire. Companies should have sufficient cash reserves in order to provide cushion and fulfill repurchase obligations for retirees.

Also, if a company sells entirely to its employees in a single transaction or is sold in its entirety with an ESOP as part of the deal—as was the case for Tribune Publishing Company—it may indicate that the owner is using the ESOP to offload ownership to employees.[131]

Not all companies engaged in these practices will put workers at undue risk. Some companies with small or only technical violations may still be selected for audit. However, DOL can focus its limited resources on employers that may truly be putting workers at risk by targeting specific practices that may be symptomatic of larger issues.

Conclusion

Employee ownership can promote workers getting a share of the wealth they help create. Research shows that these types of programs provide a host of benefits, not just for workers but also for businesses and investors. Although the vast majority of sharing programs deliver positive benefits to workers without exposing them to undue risk, there is some inherent risk in any potential reward.

The federal government should continue to promote inclusive capitalism programs while helping to ensure that the minority of companies where workers face too much risk clean up their acts. Together with the policy proposals from CAP's "Capitalism for Everyone" companion report, the policy recommendations included in this report will further inclusive capitalism in a way that mitigates risk and maximizes rewards for all workers.

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