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Employee ownership: A theoretical and empirical investigation of management entrenchment vs. reward management☆

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ABSTRACT

Employee ownership is often used not only as a reward management tool but also as an entrenchment mechanism. The literature suggests that good managers use employee ownership as a reward management tool, whereas bad managers implement it for entrenchment, thus suggesting the existence of an equilibrium level of employee ownership. The contributions of this paper are both theoretical and empirical. Theoretically, this paper fills a gap in the published research by taking into account both positive and negative outcomes of employee ownership. Our model produces three main conclusions: (i) Low-performing managers use employee ownership as an entrenchment mechanism (ii) that increases the signaling cost of employee ownership for high-performing managers. (iii) We suggest that employee ownership should not be left only to the management's discretion because both types of managers have an incentive to implement employee ownership. Our empirical study investigates how employee ownership affects management tenure. This study takes into account the two main motives for employee ownership examined by the model (i.e., management entrenchment and reward management). We find a positive relationship between employee ownership and management tenure. This result provides new evidence that employee ownership can be used as an entrenchment mechanism.

1. Introduction

The academic literature regards employee ownership as a two-edged sword. On the one hand, employee ownership is often used as a reward management tool to enhance corporate performance through its incentive effects. On the other hand, employee ownership is also used as a management entrenchment mechanism that results in poor corporate governance because of the potential collusion between employee owners and management. In the case of a hostile takeover bid, employee owners usually vote to maintain the incumbent management team. The hostile takeover bid by Shamrock Holdings on Polaroid in the late 1980s triggered the use of employee ownership as an anti-takeover device. According to Rauh (2006), this strategy was later imitated by many other US companies. Defensive employee ownership plans were also used in Europe by Société Générale against BNP Paribas in 2000 and by Gucci against Louis Vuitton Moët Hennessy in 1999. Several motivations exist for managers and employees to favor employee ownership, and these motivations will be analyzed in the next section. Blasi (1988) remarked that employee ownership could be regarded as a revolution or as a rip-off. Employee ownership could be regarded as a revolution when it improves corporate performance and leads to better workplace satisfaction. However, employee ownership is a rip-off when it is used as a management entrenchment mechanism.

The decision of implementing and developing employee ownership always lies with management. Managers would have two motivations to offer company stock to employees: to incentivize the employees or to keep their job. These conflicting points lead us to investigate management's motivations to offer company stock to employees. Although these motivations are unobservable, they can be inferred by observing corporate expenditures dedicated to employee ownership. These expenditures can take the form of a discount on company stock prize or of matching contributions in company stock. The latter mechanism is widely used in the US 401(k) plan, for instance where employers make their matching contributions conditional on employees investing in the company stock. Matching contributions are responsible for a substantial amount of own-company stock in 401(k) plans. Benartzi (2001), Holden and Van Derhei (2001) and Brown et al. (2006) find that employees' investment in company stock is higher in firms where the employer directs matching contribution into company stock; in particular, the fraction of employees' own contribution allocated to company stock is calculated to be nearly 10% higher on average. Benartzi (2001) argues that employees tend to consider management's matching contribution in company stock as an implicit investment advice and calls this phenomenon the "endorsement effect". In this paper, we

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consider that matching contributions can reveal management type. From this standpoint, management discloses its management type by choosing the amount of company stock granted to employees. Some managers use employee ownership to reward their employees, whereas others use it as an entrenchment mechanism.

Our paper thus provides theoretical and empirical findings. From a theoretical standpoint, it fills a gap by taking into account both positive and negative aspects of employee ownership, which are empirically emphasized. The theoretical model generates three main conclusions: (i) Low-performing managers use employee ownership as an entrenchment mechanism, and (ii) the low-performing managers' strategy increases the signaling cost of employee ownership for high-performing managers. Employee ownership thus used as an entrenchment mechanism by low-performing managers and as a signal by high-performing managers. These conclusions imply that low-performing managers have an interest in imitating the high-performing managers and vice versa. (iii) To solve this problem, we include prior commitment in the model which means, from an empirical point of view, that employee ownership should not only be left to management's discretion.

By taking into account the two motives of employee ownership examined in the model (i.e., management entrenchment and reward management), our empirical study investigates how employee ownership affects management tenure. Whereas other empirical studies show that employee ownership is a powerful tool to deter takeover (see Brown et al., 2006; Rauh, 2006 for recent evidence) or a powerful reward management tool (Kruse et al., 2010, 2012), our empirical study considers both sides of employee ownership and how employee ownership affects management tenure. We collect data on managers who were in their position between 1998 and 2011 in a sample of French listed companies. Controlling for several variables, we find a positive relationship between employee ownership and management tenure. This result provides new evidence that employee ownership can be used as an entrenchment tool.

This paper proposes a sequential game where a risk-neutral manager grants company stock to his risk-averse employee. The remainder of the paper is organized as follows. Section 2 analyzes the literature on incentive effects of employee ownership and its implication for corporate governance. Section 3 presents the model set-up. In Section 4, we identify the circumstances in which employee ownership is used as an entrenchment tool and as a reward mechanism and consider several extensions. Section 5 presents comparative static analyses. Section 6 displays the results of an empirical study investigating the relationship between employee ownership and management tenure. The data cover all managers' tenure in companies listed in the French SBF 120 from 1998 to 2011. Section 7 offers concluding remarks. All proofs are presented in the Appendix A.

2. Literature

The theoretical and empirical literature has always been controversial regarding employee ownership outcomes. Both the potential positive and negative effects of employee ownership are still discussed. At the employee level, the effect of employee ownership on job attitudes is debated. At the corporate level, the relationship between employee ownership and corporate governance remains unclear. However, two points of view emerge: employee ownership positively affects corporate performance through enhanced job attitudes, and employee ownership has negative effects on corporate governance.

One body of literature on employee stock ownership focuses on positive effects on employee behavior. These studies tested how employee ownership affects work attitudes with regard to implication, involvement, satisfaction, turnover and turnover intention. Klein (1987) identified three perspectives to explain the effects of employee stock ownership on employee behavior: intrinsic, instrumental and extrinsic. The intrinsic perspective states that employee ownership per se can increase employee commitment to the organization and job satisfaction. The instrumental perspective states that employee–owner satisfaction and commitment are derived from the participation in decision-making. The extrinsic perspective states that employee stock ownership is motivating when it is financially rewarding. Most of the empirical literature suggests that this last perspective explains the best employee owners' positive attitudes (Buchko, 1992, 1993; French, 1987; Gamble et al., 1999; Klein, 1987; Kruse et al., 2010, 2012; Rosen et al., 1986). Collective incentive systems such as employee ownership are often accused of stimulating free-riding behaviors. This is a major criticism against employee ownership. Kruse et al. (2010) surveyed more than 40,000 employees, where the sample was representative of the entire US working population. They investigated the relationship between shared capitalism practices, i.e., employee ownership, gain sharing, profit sharing and broad-based stock options, and several workplace outcomes, and they found that shared capitalism neutralizes free-riding behavior. Because employee stock ownership is a way to motivate employees, it affects corporate performance. In the literature, performance is measured in terms of productivity and profitability. Kruse and Blasi (1997) reviewed all of the empirical tests of employee stock ownership on performance. To summarize all the findings available, Kruse (2002) states that the empirical literature considers employee stock ownership as having either a positive or null effect on performance.

Another body of literature on employee stock ownership focuses on its negative effects on corporate governance. Employee stock ownership is regarded as a powerful entrenchment tool because it reduces the probability of a takeover (Beatty, 1995; Shivdasani, 1993). From this standpoint, management uses employee ownership to put shares of the company in “friendly hands” (Benartzi et al., 2007). The argument is that collusion between management and employee owners is natural. Pagano and Volpin (2005) states that: “managers and workers are natural allies against takeover threats” (p. 841). From the employees' viewpoint, takeovers and subsequent mergers are often associated with layoffs. Employee ownership gives employees a voice to prevent these layoffs. Faleye et al. (2006) show that “labor uses its corporate governance voice to maximize the combined value of its contractual and residual claims, and that this often pushes corporate policies away from, rather than toward, shareholder value maximization” (p. 489). Gordon and Pound (1990) argue that many employee ownership plans were established in the US during the late 1980s explicitly to defend against takeovers. When an employee stock ownership plan is implemented, event studies report negative reactions of financial markets, in line with the management entrenchment hypothesis (Chang, 1990; Chang and Mayers, 1992; Conte et al., 1996). As a takeover defense, employee ownership may be even more powerful than poison pills or golden parachutes (Chaplinsky and Niehaus, 1994). Poison pills and golden parachutes are used less frequently when employee stock ownership plans are implemented (Park and Song, 1995). Rauh (2006) confirms that employee ownership has a deterrence effect on takeover probabilities. He further claims that: “Strategic corporate control motives are, therefore, one significant reason managers encourage employees to hold company stock in their defined contribution pension accounts.” Brown et al. (2006) find that offering of matching contribution of company stock in 401(k) plans is more likely when companies do not have multiple classes of stock, which is an alternative mechanism to reduce takeover threats. According to Brown et al. (2006), employee ownership can then be interpreted as a tool to place shares in friendly hands to thwart takeovers.

According to the literature, employee ownership thus has two sides: a bright side involving enhanced corporate performance and a dark side leading to management entrenchment. These arguments can both be regarded as representing the motives of management to stimulate employee ownership. In several countries such as the US, management encourages employee ownership through matching contributions in company stock or a discount on the stock price. The level of employee ownership is the consequence of either restricting employers' matching contribution to company stock in 401(k) plans or offering discounts on company stock through employee stock purchase plans. In both cases, the level of employee ownership is left to the discretion of management.