EQUITY FOR WORKERS: A LEGAL & FINANCIAL PERSPECTIVE

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Abstract

This paper provides an analytical perspective on Employee Stock Ownership Plans (ESOPs) in the United States. It is hypothesized that employee-owned businesses will outperform industry peers in most measures of a given firm’s health. However, this model of ownership poses some unique risks to employee-owners, who may be willing to forego other forms of compensation and more diversified retirement savings accounts to acquire equity stakes in their firm. This paper will quantify the positive and negative attributes to determine if ESOPs should continue to be promoted by policymakers. There are several ways that current regulations could be improved to better protect stakeholders from “stock-drops” and breaches of fiduciary duties. The paper concludes with a comprehensive policy analysis based on past research and a review of relevant legal cases.
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Introduction to Employee Stock Ownership Plans

Employee-ownership in a business can come about in a variety of ways: profit sharing, stock options, the purchase of stock directly through a 401(k). Within any given firm, employee ownership in our economy often comes about through the establishment of Employee Stock Ownership Plans, more commonly known as ESOPs. Without going into detail, ESOPs are the one employee benefit vehicle devoted exclusively to employee ownership in the United States. The assets of an ESOP are protected through a trust, and the fiduciaries of this trust, as well as employee-owners, are subject to extensive government regulations that are meant to protect workers. In the field of employee benefits, ESOPs are somewhat of a recent phenomenon and were not recognized as a legal ownership structure until Congressional approval in 1974. Since then, ESOPs have become an increasingly popular mechanism for firms to divest shares to employees as a form of compensation and to take advantage of corporate tax benefits. Between 2004 and 2014, the number of ESOP participants has grown by 37.17%.1 Relatively, U.S. employment has only expanded by 4.3% over the same period. An increasing number of workers now find themselves as members of an ESOP, which most studies conclude has been a net positive for U.S. workers and for economic growth.2

ESOPs are portrayed as a niche, meaning that they do not impact a significant number of workers and therefore, are not worth analyzing. To the contrary, a growing number of employees are becoming involved in ESOPs, and this will likely grow as more firms and owners move to

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take advantage of the major tax advantages granted by Congress in recent years. According to
the National Center on Employee Ownership, between 2004 and 2014, the number of ESOPs fell
from 7,348 to 6,717, a decrease of 8.59%. Over this same period, however, the number of plan
participants has grown from 10,234,283 to 14,050,344, an increase of 37.17%. On the other
hand, the change in the total number of U.S. firms between 2004 and 2014 was only 4.27%, and
the change in employment over that period was just 4.3%. In other words, the growth in the
number of ESOP participants is outpacing growth in the overall economy. This means that all
signs and indicators suggest that this ownership model is here to stay. The increase in the number
of ESOP participants is even more remarkable considering that ESOPs continued to grow despite
the United States’ ongoing recession. Clearly a growing number of workers are finding
themselves in arrangements where understanding the uses and effects of an ESOP may be to
their benefit.

<table>
<thead>
<tr>
<th>Filing Year</th>
<th>Number of ESOPs</th>
<th>Total Participants</th>
<th>Active Participants</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>8,874</td>
<td>10,230,425</td>
<td>7,946,652</td>
</tr>
<tr>
<td>2003</td>
<td>7,934</td>
<td>10,049,154</td>
<td>7,570,321</td>
</tr>
<tr>
<td>2004</td>
<td>7,348</td>
<td>10,243,283</td>
<td>7,826,741</td>
</tr>
<tr>
<td>2005</td>
<td>7,198</td>
<td>11,998,319</td>
<td>9,448,271</td>
</tr>
<tr>
<td>2006</td>
<td>7,384</td>
<td>12,584,772</td>
<td>9,850,008</td>
</tr>
<tr>
<td>2007</td>
<td>7,326</td>
<td>13,218,808</td>
<td>10,173,536</td>
</tr>
<tr>
<td>2008</td>
<td>7,305</td>
<td>13,037,946</td>
<td>10,055,117</td>
</tr>
<tr>
<td>2009</td>
<td>6,690</td>
<td>12,996,711</td>
<td>10,014,524</td>
</tr>
<tr>
<td>2011</td>
<td>6,941</td>
<td>13,462,955</td>
<td>10,288,363</td>
</tr>
<tr>
<td>2012</td>
<td>6,908</td>
<td>13,823,595</td>
<td>10,603,334</td>
</tr>
<tr>
<td>2013</td>
<td>6,795</td>
<td>13,927,535</td>
<td>10,578,114</td>
</tr>
<tr>
<td>2014</td>
<td>6,717</td>
<td>14,050,344</td>
<td>10,563,219</td>
</tr>
</tbody>
</table>

The thinking is that if employees are given a stake in their employer’s business, they will work harder to generate profits, thus increasing the value of the firm and their own financial wellbeing (Kruse et al, 2010). The arguments that can be made in favor of employee-ownership center around the belief that ESOPs lead to stronger financial performance. ESOPs can be one of the primary mechanisms that Congress and other policymakers will rely on to address growing concerns over wealth inequality in the U.S.

Employees who are either involved in the ESOP from its inception or joined the firm after the ESOP has been created often forgo a wide variety of other forms of compensation. In some cases, where an employer has not established a more traditional savings plan, such as a 401(k), the only savings in employees’ names will be comprised entirely of their employer’s stocks. This can have a dramatic effect on the employee’s financial well-being, for better or for worse. It is often difficult to determine if a given employee would have been better off taking their money and investing in an index fund or a more diversified portfolio, rather than entirely in their employer’s shares. From an investor’s standpoint, all relevant information indicates that firms with ESOPs are superior to companies that do not have ESOPs. Insofar as they identify as investors rather than workers -- many employees should be quick to jump at the opportunity to create or invest in an ESOP. The primary purpose of this paper is to address the ability of employee-owned businesses to generate returns for employee-owners. The research in this paper will provide definitive support for the argument that employee-owned businesses will, on average, return more to shareholders than non-employee-owned firms.

Despite the positive attributes that can be observed at most employee-owned firms, the implementation and expansion of ESOPs over the years has drawn fire from a wide variety of advocacy groups. Perhaps the largest concern relates to how ESOPs function under the
Employee Retirement and Income Security Act (ERISA), the legislation that governs company-sponsored retirement plans. ERISA established several standards for the fiduciaries of pension plans and other benefit program trustees, but courts are relatively lenient when it comes to the prosecution of ESOP fiduciaries when employees allege wrongdoing. Unlike at most firms, where fiduciaries can only invest an employee’s retirement savings in a well-diversified portfolio, the fiduciary of an ESOP is not required to diversify whatsoever. For this reason, the retirement savings of employee-owners tend to be largely invested in their employer’s stock, creating a significant amount of single-firm risk. Diversification is perhaps the most important aspect of modern portfolio theory, but in the case of ESOPs, there is only a limited requirement on fiduciaries to ensure that plan participants’ investments are adequately diversified. Even with the best intentions, investing employee’s savings in such a way can have disastrous results.

The employees of Enron, United Airlines and countless other firms are all too aware of this. There is no shortage of court cases that suggest that policymakers will need to do more in the future to ensure that ESOP participants have a reliable source of income after retirement. When a plan fiduciary allocates a significant portion of an employee’s investments to purchase equity in a single firm, they are putting a great deal of faith in the belief that the firm’s value will not fall. The so-called “stock drop” cases highlight this important issue. Another purpose of this paper will be to analyze and discuss how regulatory policy can be changed to provide greater protection to plan participants.

While we know that ESOP firms, on average, perform better on critical measures than do non-ESOP firms, there are other things about ESOPs that we don’t know, and this paper shall

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attempt to address some of those questions. The first being, “Can ESOPs become a reliable investment vehicle for employees in the U.S.?” This is determined through a comprehensive review of financial research conducted in recent years on the topic. These studies look at worker retention, sales growth, and profitability, but perhaps the best indicator of the financial impact that ESOPs have on employee-owners will be return on equity (ROE). The second question to be addressed in this paper is, “What regulatory changes would better serve employee-owners?” This will require a review of the Employee Retirement Income Security Act, fiduciary rules, and other standards that are meant to stabilize the financial industry. Before embarking on these tasks, it is useful to examine how and why ESOPs came into being.

The first ESOP was created in 1956, and after others took note of that company’s success, the idea quickly took hold. As we shall see in the next section, from their origins, ESOPs have grown increasingly popular over the past 50 years. Furthermore, a historical analysis of ESOPs provides support to the argument that employee-owned companies can be just as, if not more, successful than their non-ESOP industry peers.
History of ESOPs

A thorough review of the major events in the history of ESOPs is worthwhile because it helps highlight some of the most important characteristics of this ownership model. The first notable examples of employee-ownership were at well-known companies such as Proctor and Gamble and Sears. These companies also had profit-sharing plans, and to keep stock values high, the management of these firms invested a portion of their profit-sharing obligations in their own company on behalf of the employees. Although revolutionary at the time, the story of the first ESOP follows what is now a markedly common pattern. In 1955, the owners of Peninsula Papers, Inc., both in their 80’s, were looking for someone to purchase the firm. The owners wanted to sell the firm to the employees, who jumped at the opportunity. However, after a local bank scrutinized the employees’ finances, it appeared that a deal would never come to fruition.

One of the company’s employees, Gene Bishop, was highly motivated to make the deal between Peninsula’s employees and owners. Bishop consulted with Louis Kelso, an attorney in the San Francisco area. After reviewing the relevant finances, Kelso structured a deal that would allow the employees to purchase Peninsula at no cost to themselves. Kelso remembers saying. “‘Gene,’ I said, ‘this thing will fly like a birdie. You don’t have to take anything out of your pockets or out of your paychecks. You don’t have to mortgage your house. You don’t have to do any of those things. Five or six years downstream, the employees will own the business free and clear. And the present owner will have his money and his interest.’ Gene thought I was kidding, but I was not.”

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It is worthwhile to consider the workings of leveraged buyouts. In a leveraged buyout, a company uses borrowed money from a commercial bank to acquire another firm. A transaction structured as a leveraged buyout can help small business owners sell their companies when they are ready to retire. Banks are more likely to provide loans to growing and profitable companies than those that do not show much promise.5

At the start of a 100% buyout, employee-owners borrow bank money to acquire the target firm, they become beneficial owners of all shares in the firm, they place those shares in a trust fund, and they simultaneously pledge all the shares as security for the bank loan. Employees create a trust that collects profits from the firm over time. As the firm makes money, that revenue is used to pay off the bank loan, and as the firm makes loan payments, with each loan payment made, shares are released from the bank’s security interest in those shares, and the shares are credited to individual employee accounts. This continues until the bank loan is paid off entirely. The employees will then own the firm’s equity. However, the process of paying off the loan can take years. If the firm becomes more profitable over time, the ESOP trust will be better funded and thus, capable of paying the loan off more quickly. Over the years, the ESOP at Peninsula Papers acquired more and more of the newspaper company’s equity. The employees who stayed with the firm realized a massive return on their investments.

Kelso became more involved in facilitating ESOP deals and eventually brought his case to Washington D.C. In 1964, Kelso’s ideas were quickly dismissed by Milton Friedman, one of the most famous economists of his era. In 1972, Kelso attempted once more to convince policymakers on the merits of employee-ownership. Kelso met Russell Long, a Democratic

Louisiana Senator who sat on the Senate Finance Committee. Long was skeptical and wondered, “If everyone was an owner, would they be like the idle rich, never working? And if this was such a good idea, why hadn’t it already gone further? Who was against it?” Kelso’s relationship with Long proved to be fruitful, and Kelso spend the next several years working in D.C. to promote employee-ownership. Kelso’s ideas became widely accepted in political circles because of bipartisan support.

Policymakers believed that ESOPs could become an effective means of increasing the financial status of the middle class. Kelso’s politically-driven arguments for employee-ownership are still very much applicable in our current economic climate. A growing number of politicians from both sides of the aisle are concerned that Americans are not saving adequately for retirement. A growing number of retirees will need to turn to government programs to maintain their standard of living. Ernst & Young estimates that 59% of middle-class retirees will outlive their retirement saving. Consider the graph below.

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6 See Footnote 2
Senator Long and Kelso were able to convince Congress to conduct a study on the effects of employee-ownership that took place throughout the 1970’s. ESOP’s, however, were not legally recognized until 1974 when Senator Long and the Senate Finance Committee placed provisions regarding ESOPs in ERISA legislation (more on these provisions and ERISA to come.) It is worth noting that until 1974, Kelso’s use of loans and trusts to acquire firms was a subject of great controversy. The ERISA provisions that relate to ESOPs helped to address some of the skepticism. From that point forward, all ESOP legislation came in the form of ERISA amendments and changes to the tax code. Over the years, the Senate Finance Committee, under the leadership of Russell Long and one of his successors, Senator Jack Curtis, worked to pass
laws that provided stronger incentives to employee-owned businesses. One of the first pieces of legislation was the Tax Reduction Act of 1975, which created a system that rewarded firms with tax credits on capital expenditures for contributions to an ESOP. Another piece of tax legislation came in the Economic Recovery Tax Act of 1981, an interesting system where the government bought company stock and reissued the stock to employees. There were also special measures passed such as the Chrysler Loan Guarantee Act, that explicitly required companies to create ESOPs.⁸

Today, a key feature of the ESOP is its tax benefits. If one corporation agrees to buy another company, the owner of the sold stock will often be compensated in the acquirer’s stock. The owners can then defer the capital gains tax on the proceeds. In 1984, a Senate Small Business Committee Staffer, Corey Rosen drafted a bill that allowed owners who sold their stock to ESOPs to defer their capital gains tax. Senator Rosen may have had ulterior motives, as he was in the processing of selling his own company to a group of employees at the time.⁹ The tax provision that allows for the deferral of the capital gains tax has been one of the key incentives for the creation of thousands of ESOPs over the years. Since 1984, millions of employees have found success through the creation of ESOPs, and there have been hundreds of studies conducted to quantify their effects on firm performance. Despite the generally positive findings, ESOPs have not been recognized for their true potential.

The following section of the report is a literature review that encompasses a wide range of information that pertain to the issues and merits of ESOPs.

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⁸ See Footnote 2
⁹ See Footnote 2
Literature Review

This section of the report analyzes information made publicly available by organizations such as the National Center for Employee Ownership (NCEO), Employee Ownership Foundation, and The ESOP Foundation. These associations collect data on the financial performance of employee-owned businesses in the United States.

Several universities have conducted research to better understand the qualitative effects of employee ownership on such subjects as innovation and worker satisfaction, which are important, but not pertinent to this study. On these measures, these studies suggest that majority-owned employee-owned businesses outperform companies that are not majority owned by employees. This study differs from these others by focusing on quantitative measures of performance. Limited research has been conducted on whether employee-owned businesses’ can outperform other firms. This is because financial information about privately-held companies is rarely made available to the public.

The National Center for Employee Ownership is a nonprofit organization that conducts research on Employee Stock Ownership Plans, equity as a form of compensation and progressive ownership models. The purpose of the NCEO is to educate the public and corporate officials on the benefits of broad-based ownership models. Ownership can come in several forms, including stock ownership plans in public companies, broadly granted stock options and similar equity rewards, and employee stock ownership plans (ESOPs). The NCEO found that ESOPs held more than $1.2 trillion in assets in 2010. This is significant considering that this represents 4.7% of
tradable equity assets in the U.S. The market capitalization of all U.S. stock as of early April 2017, was $25 trillion.¹⁰

The NCEO found that ESOP participants have three times the retirement assets of employees in comparable companies. Additionally, ESOP participants earn 5% to 11% more in wages each year than comparable employees. These findings support the claim that ESOPs are more likely to create measurable wealth for employees than are pension plans or traditional 401(k)s. Despite these promising signs, the NCEO places a disclaimer at the end of their analysis:

“Performance effects are not automatic, however. Research consistently shows that the companies that combine significant annual contributions to an ownership plan with regular, structured opportunities for employees to participate in decisions affecting their jobs and who routinely share information about company financial performance with employees perform far better than those who do not.”

Critics of broad-based ownership believe that employees who are receiving larger salaries and equity must make concessions in other terms and conditions of employment. But ideally, employees will not have to give up other benefits in exchange for equity. If accurate, the concessions argument means that employees are in a position where they are asked to forfeit valuable employment contract provisions, such as future pension benefits and healthcare.

**Addressing Wealthy Inequality**

“The 2,000 full-time employees of the yogurt company Chobani were handed quite the surprise on Tuesday: an ownership stake that could make some of them millionaires” …” Two

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years ago, when Chobani received a loan from TPG Capital, a private equity firm, the company’s value was estimated at $3 billion to $5 billion. At the $3 billion valuation, the average employee payout would be $150,000. The earliest employees, though, will most likely be given many more shares, possibly worth over $1 million."

“It’s better than a bonus or a raise,” Mr. Lake said. “It’s the best thing because you’re getting a piece of this thing you helped build.” …” Technology start-ups often pay employees partly in shares to help recruit them or to compete in a company’s early days for in-demand workers. Early employees of Google and Facebook became overnight multimillionaires thanks to such compensation.”

ESOPs are not as widely used as other retirement investment vehicles, but this does not mean that they are any less effective at generating positive returns for the employees, which may help to explain why ESOP accounts may be created in lieu of bonuses or benefits. ESOPs have played a much larger role in recent years as workers become further educated on the investment opportunities available to them.

There are a variety of reasons that may motivate an employer to distribute equity to their employees through an ESOP and its steady vesting process as opposed to through traditional investors in the larger financial market. These reasons are discussed in this thesis, as an owner’s intentions are often indicative of the quality of the arrangement that a group of employees may find themselves in when they have established an ESOP, be those intentions benevolent or malign in nature. Professor Paul Whitehead, a faculty member of the Pennsylvania State University’s School of Labor and Employment Relations, recalls an instance in which a long-

time union-side lawyer exclaimed, “Any firm that wants to give itself to its workers is a ‘dead duck’.” Employees are not wrong to be skeptical when an owner proposes to sell to them after having failed to sell the firm on the open market. In other words, employees do not want to become the buyers of last resort.

The employee-ownership Kelso discusses in his books, *Capitalist Manifesto* (1958) and *The New Capitalist* (1961), while revolutionary, was largely conceptual and lacked empirical evidence. The purpose of this thesis to determine the validity of Kelso’s concept of employee-ownership by demonstrating how ESOPs create value for workers in terms of investments and socioeconomic status.

“If capital ownership is good for the rich, it is a thousand times better for the middle class and the poor.” - Louis Kelso

The Center for American Progress, which conducted research for former presidential candidate and Secretary of State Hillary Clinton, recommended that tax breaks should be expanded to companies that create ESOPs. It is the combination of tax incentives, potential for improved productivity, and the underlying belief that it is inherently good for society that more people participate in the capitalist system that has generated significant bipartisan support for wealth dissemination through employee-ownership schemes.

“The Roman arena was technically a level playing field. But on one side were the lions with all the weapons, and on the other the Christians with all the blood. That’s not a level playing field. That’s a slaughter. And so is putting people into the economy without equipping them with capital, while equipping a tiny handful of people with hundreds and thousands of times more than they can use.” - Louis O. Kelso, Bill Moyers: A World of Ideas, 1990
There are few matters in contemporary society more important to address than that of wealth inequality, the gap in earnings between the rich and the poor. In 2014, the Pew Research Center conducted a survey of 1,500 Americans and found that 69% of respondents believe that the government should take actions “to reduce the gap between the rich and everyone else.” Furthermore, it has been found that interest in the issue transcends financial status. For example, Benjamin I. Page and Jason Seawright of Northwestern University and Larry M Bartels of Vanderbilt University found that 62% of wealthy individuals in the Chicago-area felt that “differences in income in America are too large.”

From the Democratic side of the aisle there are the expected demands for a progressive tax system and limiting the take home of the wealthiest workers, the proceeds of which would then be redistributed to lower earners via subsidies and other forms of social programs. From the other, it is said that such actions would only restrain the economy further and would hurt small business owners, which only augments the wealth gap.

The leading political stances offer two perspectives on the issue. The first suggests that the only way that this can be accomplished is through removing some of the barriers that restrain the upward mobility of the working class, suggesting that given the proper regulatory environment, namely one that encourages free enterprise and limited government intervention, the average worker would ultimately find their way into a stable and well-compensated job. Only 17% of wealthy respondents in the survey described above indicated that they felt that government should “redistribute wealth by heavy taxes on the rich,” and that only 19% of

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wealthy respondents, as opposed to the two-thirds of the public, felt that the government should “see to it” that jobs are created for the unemployed.  

On the other hand, more progressive legislators believe that the current system is distorted in such a way that maintains the disproportionate status quo and serves high earners, such as fund managers and corporate executives, at the expense of the middle class. In a 2011 op-ed written for the New York Times by famed investor Warren Buffet, despite having the highest salary in his office, his taxable income only amounted to 17.4% of earnings, while his employees’, earning significantly less, faced a much steeper tax rate, which averaged 36%. He contends, as we all should, this is a flawed system.

A Solution for Inequality

Clearly, members of Congress disagree over the role that the government should play in creating economic opportunity. Rhetoric from both major parties and industry officials involved in the matter, it also clear that this issue will not simply go unaddressed. Looking at recent trends in the workplace, many people believe that the government should do more to address the issue of economic equality, but remain undecided on how to create policies and protections that would instill a sense of economic liberty. The belief that the government should play a limited role in wealth redistribution may also explain why profit-sharing and ESOPs have received some, but limited support from current policymakers. Although government gridlock may have spurred the efforts that can be observed in the private sector to democratize the capitalist system. Those efforts would provide employees with a much larger share of the equity in the firms they

13 See Footnote 10
work for, it would be in the best interests of the government to bring profit-sharing schemes and ESOPs under tighter regulation until all their benefits and risks can be accurately gauged.

This thesis was written because all signs and indicators suggest that ESOPs will cover more workers as corporations begin take advantage of favorable tax policies only available to ESOPs to address inequality. This is likely because the government will need to stimulate consumer spending and address wealth inequality in the coming years.\textsuperscript{15} It is important that the reader understand what economic transitions have encouraged organizations and groups of employees to seek equity redistribution in their firms. The second portion of this literature review will discuss the wisdom of workers’ decision to become involved in employee-ownership schemes.

\textit{“On the corporate side, studies of ESOPs in closely held companies show that, relative to comparable companies, ESOP companies’ sales, employment and productivity grow about two percent to three percent faster per year after they set up an ESOP than they had been growing relative to the same companies before the ESOP. In public companies, the effect is more uncertain. Some studies show a strong positive effect, others a somewhat negative impact. These plans usual own less than 10% of company stock and are rarely integral to a company’s culture.”}\textsuperscript{16}

Based on what has been discussed in this literature review to this point, it should be clear to the reader that in practice, ESOPs, when properly managed, provide greater opportunities for employees to participate in retirement planning, investments, and to influence decisions being


made at the highest levels of the firm. However, as is the case in all investments, history indicates that ESOPs present their own unique set of risks to investors. This inherent risk should be kept in mind by employees who are in the process of establishing an ESOP or purchasing more equity in their employer’s firm. The sources of this risk and guidelines for avoiding it will be discussed later in this paper.

**Conducting Valuations and Single-Firm Risk**

“The Labor Department is the plaintiff in 15 lawsuits related to employee-stock-ownership plans, with ‘virtually all’ the cases alleging shoddy estimates of what a company's shares are worth, said Timothy Hauser, a deputy assistant secretary at the agency's Employee Benefits Security Administration.17

"Valuation is the first, second, third and fourth problem," Mr. Hauser said. ...Labor Secretary Thomas Perez told lawmakers that some appraisals "have been deliberately inflated," comparing them to real-estate-bubble-era home appraisals that "masterfully came in at what you needed."18

Issues that may arise when employers compensate their employees in the form of an ESOP that rewards employees with equity in their employer’s firm based on seniority and rank. While ESOPs have become popular because of their effects on employee retention and significant tax incentives to the more than 6,800 U.S. firms that have implemented such a system, given current regulatory standards, ESOPs should not replace more traditional savings plan, namely 401(k)s.

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18 See Footnote 17
ESOPs are supposed to align the interests of the firm to those of the employees. As noted in the question above, there were 15 lawsuits brought by the Labor Department accusing owners of selling ESOPs shares at inflated prices to employees.19

“In contrast, when the owners of People Care Holdings Inc. sold the home-health-care provider to employees in 2008, the shares were valued at about $8 apiece. By the end of 2012, the stock was worth just nine cents a share. "I thought it would be more," said 61-year-old employee Norva Morris-Lewis, who earns $10 an hour and has no other retirement savings.”20

This indicates that shareholders in privately-held ESOPs are exposed to more precariousness simply because of a flawed valuation process. This deficiency makes ESOPs inherently riskier than a 401k, without corresponding differences in returns. Furthermore, it is noted that 95% of ESOPs are closely held, making the people conducting appraisals overly reliant for financial information on current proprietors, who stand to gain the most from inflated values. Critics of ESOPs say that ESOPs should not replace 401ks, not only because of the susceptibility to overvaluation described above, but also because average returns fall short of what might be observed in a traditional savings plan.

There is more that could be done to regulate ESOP valuation, but to advise against investments in this entire asset class is unwise. From an employee’s perspective, ESOPs often come at little to no costs as part of a larger benefits package. Furthermore, returns on ESOPs exceed 401k plans regularly and can be an effective way to hedge against macroeconomic risks.

19 See Footnote 17
20 See Footnote 17
The issuance of ESOP shares has also been an effective way for small to medium sized firms to raise capital without going public.

"Are there thousands of American workers that are getting harmed and hurt by a significant number of flimflam ESOPs? I don't see it." - J. Michael Keeling, President of the ESOP Association

Corey Rosen is the founder of the National Center for Employee Ownership, a research group with members that include companies with employee-stock-ownership plans and firms that pitch services to these companies. He has said there are "people who use" such plans "badly." Overall, though, "the opponents of ESOPs have no data," he adds, "just impressions and anecdotes." The comments of Rosen and the previously quoted Keeling’s call for greater government and private efforts to support employee-owned businesses. The discussion above indicates that ESOPs require a standardized valuation process.

“Bulldozer operator John Vincent got 18,500 shares of company stock, once valued at roughly $65,000. Soon after the sale was completed, the company cut its revenue projections by roughly 50%, according to court filings. The company shut down in 2010. Its shares are worthless.”

Policy Issues

“America leads the way: 32 million Americans own stock in their companies through pension and profit-sharing plans, and share-ownership and share-option schemes. The idea continues to gain momentum. Hillary Clinton’s recent speeches suggest that she may make it an

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21 See Footnote 17
22 See Footnote 17
important plank in her plans to reform capitalism. And worker-capitalists are also on the march in Europe and Asia.”

Although Hillary Clinton lost the election, her vision of expanded broad-based ownership for U.S. companies will supposedly be part of the Trump Administration’s plan to provide tax cuts to firms meeting ESOP criteria. Employee-ownership has several risks that can only be addressed through changes in regulations and industry conduct. The first issue arises when employees have “too many eggs in one basket.” When firms go bust, employees in ESOPs lose their jobs and large portion of their savings and retirement income. Defenders of ESOPs insist that the “lack of diversification” argument is weak. It assumes that companies with ESOPs are substituting the ESOP for a diversified retirement portfolio. It is far weak at ESOP companies using 401(k)s and defined benefit plans to supplement their ESOP. Furthermore, more and more ESOPs diversify assets in the plan over time. An ESOP Manager will transfer some of the assets of the ESOP from older to younger employees. The proceeds from the sale of the older employee’s equity are then invested in a more diversified retirement account. However, consider the cases of Enron, Global Crossing and RadioShack below:

“Enron employees were encouraged to stuff their “401(k)” plans (the most popular type of pension scheme) with company stock. Just before the firm went bankrupt in 2001 the average employee held 62% of his or her 401(k) assets in Enron shares. Likewise, when Global Crossing went bust a few months later, the collapse in its shares wiped out a large chunk of its workers’ pension savings. Despite various initiatives by Congress to stop firms touting their shares to employees, cases are still arising: some former workers at Radio Shack, a retailer that filed for

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bankruptcy in February, are taking the firm to court, arguing that it kept offering to make its pension contributions in the form of company shares, when it should have known they were going to lose value."\(^\text{25}\)

Unfortunately, the three cases described above demonstrate the need for more employee protections, particularly when managers encourage employees to invest in their firm’s stock. Financial advisors for ESOPs should play a more active role in diversifying assets, and if they are limited by statute, mandated diversification is certainly a plausible solution to the issue. This could be accomplished by asking that employers to provide alternative investments or by requiring that shares in the employers’ firm do not make up a disproportionate amount of an employee’s savings. Post-Enron, employees were given limited rights to diversify in 401(k)s, not ESOPs. Public policy has taken a significant step in the direction of the recommendation of this paper. The risk that can be created when employees depend on the same company for both their paychecks and their retirement accounts cannot be ignored.

One of the ways that ESOP companies have addressed risk has been to ensure that employees have access to secondary retirement plans. In 2013, Plansponsor Magazine found that, “95% of ESOP companies offered 401(k) plans compared to 86% for respondents overall.”\(^\text{26}\) This means that ESOP firms are more, not less, likely to provide an alternative savings plan.

However, in a head-to-head comparison between ESOPs and 401(k)s, The Department of Labor found that ESOP retirements plan with at least 100 participants outperformed 401(k) plans between 1991 and 2010. Perhaps more importantly, the standard deviation of scores for the


periods between 1991 to 2000, 2001 to 2010 indicate that ESOPs may be less volatile than 401(k)s. Consider the data provided by the Department of Labor below.

<table>
<thead>
<tr>
<th></th>
<th>401(k) Plans</th>
<th>ESOPs</th>
</tr>
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<tbody>
<tr>
<td><strong>Mean Rate of Return</strong></td>
<td>7.8%</td>
<td>9.1%</td>
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<tr>
<td><strong>Standard Deviation</strong></td>
<td></td>
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<tr>
<td>1991-2000</td>
<td>11.2%</td>
<td>11.1%</td>
</tr>
<tr>
<td>2001-2010</td>
<td>13.5%</td>
<td>12.4%</td>
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<td>2006-2010</td>
<td>15.5%</td>
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<tr>
<td>2008-2010</td>
<td>19.3%</td>
<td>17.0%</td>
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*Figure 3 Comparison of Rate Return and Volatility*
Governance Perspective

This section of this report provides the reader with an understanding of how ESOPs are established, maintained and governed.

When an ESOP is first proposed to employees, they may feel overwhelmed because of the financial and legal complexities involved. There are a variety of ways that an employee can go about becoming an owner. Perhaps the simplest way is for the employee to purchase stock directly, an option that is readily available when the firm is publicly traded. Other common methods of acquiring equity in the firm can come in the form of stock options and profit sharing. This section of the paper will describe in basic terms how and why an ESOP is formed.

The methods of forming an ESOP have not changed much over the past four decades. Among two of the most common methods is, first, the company establishing a trust to contribute shares of equity or cash that will be used to purchase its own stock, and the second employees borrowing from a lender. In the latter method, the company contributes a portion of profits to the ESOP so that it can make payments on the loan. During the entire process, a single trustee or group of trustees are appointed who make sure that the ESOP is adequately funded to make stock purchases and loan payments.

Over time, as the loan is paid off, shares of the company’s stock are credited to individual employee accounts. The amount that is ultimately credited to an individual account is determined by their compensation as a percentage of the total compensation of all employees in the ESOP. For example, managers often receive a greater portion of the shares than lower-level employees. Although ESOP shares begin to accrue immediately in an employee’s account, many firms require employees to stay with the company from 3 to 6 years before the individual employee has the full right to these shares. Even after an employee has become 100% vested, they cannot
cash out on their shares in the firm until they leave the firm. The lack of liquidity can create problems when employees want to cash out en masse, as is often the case when investors learn that a company is going to lose a significant portion of its value.

During the 2008 financial crises, fund managers of non-ESOP mutual and hedge funds had to freeze withdrawals to prevent customers from cashing out. Perhaps the most famous example of this was at BNP Paribas SA, the firm that sparked the financial meltdown by freezing withdrawals from its three largest funds that were highly exposed to mortgage holdings. Legally, freezing withdrawals has been deemed acceptable by regulators because if funds allowed many customers to withdraw all at once, the fund would need to resort to fire sales of assets to meet redemptions. More recently, Third Avenue Management decided to freeze withdrawals from a $788 million credit fund.\(^\text{27}\) Regulators allow fund managers to do this during brief periods of time to maintain stability in the financial markets during panics, but it is expected that the funds will eventually unfreeze these accounts and honor cash-out requests.

A key difference between hedge funds and an ESOP is that ESOP participants are not allowed to liquidate their shares until much later in their careers. Generally, only employees who are nearing retirement can diversify half of their ESOP account value into investment funds. This means that employee-owners can be left with equity whose value is quickly deteriorating. In either case, ESOP participants cannot cash out on their shares freely.

This does not mean that employees are entirely powerless if the firm is headed in an alarming direction. ESOP participants, like all investors, can vote their shares on important issues that relate to acquisitions, closing and relocating. ESOPs will typically appoint members

to the corporate board of directors to make these decisions and can vote on new appointees as well. If the individual they elected fails to represent employee interests, they can be replaced when their terms expire. Voting on major issues is often contentious. At times, this can put the ESOP at odds with the company’s management, other investors and even among employee-owners themselves. Most companies with ESOPs are not 100% employee-owned. As might be expected, the firms that are 100% employee-owned do not have nearly the same difficulty as those that are not when it comes to making decisions about the firm’s future. For example, there are potential clashes between ESOP-elected and investor-elected board members when these parties cannot agree on a price to sell in the event of takeover over merger. On the other hand, there are few people who understand the inner workings of a company better than its own employees. This means that they may be more knowledgeable decisions than investors from outside of the company.

When an employee does leave the company, often to retire, the firm is obligated to buy back the shares at the fair market value in a privately held company or the public market value for a publicly owned company. Private companies are required to conduct annual valuations to determine the fair market value of the firm. The firms that are hired to conduct company valuations are selected either by the owners in the case of ESOPs that have not yet been established or by management personnel for each of the years that follow. This represents a clear conflict of interests for the company conducting the valuation. Owners will want to maximize the firm value and can fire valuation company A if it issues a low valuation whereas company B would peg the value higher. Furthermore, the owners of a firm are asked to provide valuators with relevant information to determine the fair market value. It may be tempting for owners to provide valuators with selective information that does not reflect the true value of the company.
The price mechanism of a public market is not available for the valuation of the stock of privately-held ESOPs, so gauging a closely-held company’s value can be difficult. Students of the efficient market hypothesis will understand the difficulties that can flow from the fact that the value of privately-held firms are not tested by trading in capital markets. To safeguard against the dangers in this respect, employee-owners should play a larger role in the selection of the valuator. Additionally, valuators should be held liable if their valuations result in a significant loss for employee-owners shortly after the ESOP is created.

Interview: Jim App – Former CEO and Current Corporate Board of Directors and ESOP Board of Trustee Member of L/B Water on Corporate Governance:

App describes how the ESOP at L/B Water, an industrial supply firm located primarily in Pennsylvania, was established: “When an organization is first incorporated as an ESOP, they appoint a trustee. In our case, outgoing board members selected our existing board, which has been comprised of the same members since 2000. There is a process that allows ESOP-participants to have a say over who is on the board, but we have yet to experience this [the replacement of an incumbent corporate board member]. I’d like to think that the Board and the employees can share credit for the success of L/B.” Since 2000, L/B’s shares have grown in value from 71 cents to $3.02 per share. This represents an increase in value of nearly 320%, a substantial return on equity. Furthermore, in 2017, there will be approximately 30 employees who have an ESOP shares presently worth $1 million in their accounts, a generous reward for their years of dedication to the firm. App shared that many of the people in this category do not have an education beyond a high school, but, he goes on to say, they made the most out of the opportunity presented to them at L/B and can take pride in their achievements.
While discussing governance, App suggests that there are a few dynamics to keep in mind. “As the Board of Directors, our job is to look at the overall health of the company. We need to make major decisions that impact everyone. One of my fundamental beliefs is that there needs to be a separation between the board and employees who are involved in the day to day operations, including the CEO and CFO.” Thus, as App sees it, when management remains on the board of an employee-owned firm, there are many situations that can lead to a conflict of interest.

App believes that the corporate board’s job is to mentor and guide the company by staying engaged. Similarly, the board needs to be careful not to interfere with management’s decisions beyond holding them accountable. “We strive to make informed decisions by maintaining a diverse board. Currently, we have two outside independent members on the Board (of five total board members).

App says that in recent years, the Board of Directors has played an important role in the expansion of the firm, most recently through acquisitions in Virginia. “At first, there were growing pains. We found was that it is extremely difficult to integrate company cultures during acquisitions. This is especially true at an employee-owned business where individual efforts can have a huge impact on the financial wellbeing of other employees. L/B is known for having a strong work ethic because of this understanding. “Each day, I ask myself, what can I do to make things better tomorrow than today? If we don’t ask ourselves this, we lose our desire to grow and become stagnant. Everyone at an ESOP should ask themselves this, from the guy that sweeps the floor to the person who sells $10 million worth of equipment.”

My interview with App highlighted a few overriding issues. The first is that ESOP participants do not enjoy the same level of liquidity as other investors. This means that they can
be stuck with shares that are declining in value with no remedy besides to leave the firm. The second issue pertains to the fact the interest of employee-owners is not always going to align with some members of the board of directors. This can become an issue for publicly-traded firms involved in hostile takeovers, because employee-owners are going to do everything in their power to keep locations open and avoid closures. By comparison, non-employee investors view things without worrying about their employment security and will want to sell if they receive a fair bid. The third issue relates to inherent issues in the valuation process. For the reasons described above, there are many opportunities for conflicts of interests regarding valuation to arise. Despite these concerns, employers continue to create ESOPs. The fourth and final issue that needs to be addressed in the future is how employees can take advantage of the ESOP benefits without taking on excessive risk in their retirement portfolios. Companies have addressed this in the past by ensuring that employee-owners have two retirement accounts, the ESOP account, as well as when a traditional 401(k) savings plan or other defined contribution plan. 401(k) plans are inherently better diversified, but not every company provides them. This puts the employees in a precarious situation. These matters will be addressed in the policy analysis at the end of this report.
Why ESOPs are Created

ESOPs are created for three primary reasons: as a succession plan for departing owners; to reap the benefits of tax advantages only available to ESOPs; and lastly, as a way of creating additional employee benefits. However, a fourth motive for a firm to set up an ESOP occurs when the company trying to find a buyer is unwilling or unable to find a better deal. Imagine a scenario where an owner wants to sell to another company, but is unable to find a buyer on the open market. The owner might then sell to the employees at a lower cost than previously planned to reap the tax deferral advantages. In such a case, employees may be enticed into setting up an ESOP to purchase the company at a discounted price. In such a scenario, the employees may not be as concerned as they should be that no other companies were willing to make an offer. This means that the employees became the purchasers of last resort for the firm’s original owners.

According to the National Center on Employee Ownership (NCEO), “Owners of privately held companies can use an ESOP to create a ready market for their shares.” This can occur in two ways. The first was used in the Peninsula Papers example described earlier in this report, in which a group of employees used a loan to purchase the firm. This method is most practical when an owner is not interested in cooperating with an ESOP for an extended period; they take the offer and walk away. The second requires more involvement from the departing owner. Employees may also decide to make tax-deductible contributions to buy out the owner’s stake. This process will likely take longer than the former approach in which a loan is used to purchase the firm is purchased outright.

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Another use of ESOPs is simply as an employee benefit. A useful tool in recruiting and retaining human capital. ESOPs at public companies, which account for 5% of ESOP plans and over 40% of participants, typically offer an employee savings plan in addition to the ESOP plan. Firms have two options if they make matching contributions to the employee savings plan. They can make cash contributions to match the employee’s own contribution or they can contribute company stock to the plan in an equivalent value. This is a valuable option to firms that are short on capital, but willing to dilute equity. In other words, when given the opportunity, most companies will choose to conserve cash for a variety of financial reasons, but most likely to make the firm look healthier to investors than it truly may be. To find out more about why ESOPs are created. The author interview a seasoned expert at an ESOP consulting firm.

Interview: Mark Pulaski – Principle at Cornerstone Advisors, Allentown, Pa.

Over the course of his career, Pulaski has observed that firm performance differentials between ESOPs and non-ESOPs are not explained by the mere presence of an ESOP, but rather the amount of equity that is controlled by the ESOP participants. Pulaski says, “If you are going to have an ESOP that is not majority owned by employees, it is much more of a benefit plan approach than an incentive plan.” This means that firms that have more of a benefit plan will not observe significant changes in firm performance. In an organization where employees do not hold much equity, employees will view the ESOP simply as a retirement plan. This does not motivate them to stay like an incentive plan would.

Pulaski also suggests that the reason that a growing number of owners are creating ESOPs is because of liquidity. In the eyes of the owners, the employees are potential purchasers.

This means that the employees, on their own, are expected to carry out the necessary due diligence. When should ESOPs be avoided? Pulaski says there are four factors to consider when employees are making this decision, first is, the size of the employee base, with the advice being, “the bigger the better.” Second is, the amount of revenue the firm is bringing in. Establishing an ESOP can be expensive. Consulting fees can range from $50,000 to $100,000 to set up the ESOP and then $15,000 to $30,000 per year to maintain.\textsuperscript{30} Pulaski believes that not all owners are just looking for a way out, but also are “motivated to see their company grow after they depart.”

Methodology

Because many ESOPs are privately-owned, it is difficult to collect data on them. One of the ways that researchers have addressed this dilemma has been to survey the employees of ESOP organizations. Over the last 20 years, 12 relevant sources have been published, and this research project consists of reviewing and scrutinizing the sources to determine how ESOPs function and whether they can be improved. Eleven of the 12 studies have examined ESOP firms’ performance. The remaining source uses data from the Toronto Stock Exchange to make its points. Two of the studies were a “study of studies”, or meta-paper, that compiled the data of 70 past researchers. This project takes a similar approach. It uses the data provided by the 12 sources to test the hypothesis. The 12 studies included in this paper were suggested by the National Center for Employee Ownership as the most relevant studies proving the effects of employee-ownership on firm performance.

In the field of ESOP research, studies have looked at; the return on retirement savings, Tobin's Q\textsuperscript{31}, return on assets, net profit margin, return on equity, sales growth, sales growth per employee, market value, productivity (output per worker), employment growth, wage growth, and profitability. Researchers look at the financial metrics of ESOP companies and compare them to industry peers without ESOPs, meaning that they generally controlled for macroeconomic effects to create better comparisons. The researchers also compared performance before the ESOP was created to performance five to 10 years after the ESOP was created. Based on the observations of this researcher, all 12 of the studies were conducted using valid scientific methodology. The findings of these past studies have been compiled to create a meta-analysis of the performance of businesses that have an ESOP. Additionally, only the data that the

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\textsuperscript{31} The market value of a company’s assets divided by the replacement costs of a company’s assets (book value).
researchers found to be statistically significant was included for this thesis. A description of each of these studies follows:

1. The most comprehensive study, *An assessment of employee ownership in the United States with implications for the EU*, was conducted in 2003 by researchers Joseph Blasi, Douglas Kruse, James Sesil and Maya Kroumova. They found 70 empirical studies on ESOPs and analyzed them for what they taught regarding the effects of employee stock ownership, broad based stock options, profit sharing, and employee participation. The 70 studies included three kinds of comparison: longitudinal studies (before and after), between groups (ESOP and non-ESOPs) and within groups (for example, ESOPs with 20% ownership compared to those with 100% ownership). According to Joseph Blasi, “The results surprised even us, not because they were so positive, but because they were so extensive and so uniform…. The most striking conclusion: Every major study found that investors came out ahead if their company adopted key elements of partnership capitalism.” Overall, the authors found that ownership by means of an ESOP produced 12% increase in return on equity, an 11% increase in net profit margin, a 14% increase in stock return (for publicly-traded companies) and a 4% increase in productivity.32

2. A similar meta-analytical report commissioned by the World Institute for Development Economics Researcher, *Sharing Ownership via Employee Stock Ownership*, was conducted in 2001 by researchers James Sessil, Douglas Kruse and Joseph Blasi; three of the four researchers who were involved in the research paper discussed in the previous paragraph. This report looked at 50 empirical studies that covered topics such as employee attitude, firm

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performance and wages. In this study, researchers found that ESOP firms were 6.2% more productive than non-ESOP firms and that ESOP firms had a 4.4% increase in productivity after the adoption of the ESOP plan.³³

3. The Journal of Financial Economics, Volume 76, Issue 1 published a study in 2005 titled, *Why do some firms give stock options to all employees? An empirical examination of alternative theories.* The study was conducted by Paul Oyer and Scott Schaefer. These researchers looked at the effects of stock options on employee’s savings at 798 firms (390 of which had ESOPs) in the United States. They found that there was a direct effect on employees’ savings when employees acquired equity in the firm in the form of an ESOP or Stock Options. Stock options give employees the option to purchase the stock at a discounted price in the future if the firm’s stock value rises. If the firm’s value falls, they will not exercise the option, and this means that the options will expire valueless. The researchers used a Black-Scholes model to find the return on retirement savings for ESOP plan participants. The Black-Scholes model is useful to evaluate stock options because it accounts for the price variation of the stock, the time value of money, the strike price and the time to the options expiration.³⁴ Oyer and Schaefer found that the average employee’s retirement account value increased by 106.7% over the same 4-year period. The return on equity was 28.91% for investors, including ESOP plan participants and public holdings, and employment grew by 12.2% over a 4-year period.

4. A 1998 study was conducted by Peter Kardas and Jim Keogh from the State of Washington Department of Community, Trade and Economic Development. These researchers used data

from the Washington State Employment Security Department and matched 102 ESOP companies with 499 comparison companies based on their industrial classification. The researchers found that the median wage at ESOPs was between 5% and 12% higher than the median wages of the non-ESOP companies in the sample (average of 9.5%). They also found that average value of retirement assets at ESOP companies was $32,213 and only $12,735 at non-ESOP firms. The return on retirement savings at ESOP companies was 153% higher than that of non-ESOP companies. It is not clear if these savings were eventually converted to cash.35

5. The Toronto Stock Exchange (TSE) provides valuable insight on the financial performance of ESOPs. The Toronto Stock Exchange tracks the performance of ESOP firms that are publicly traded on their exchange. Between 2003 and 2008, the TSE found that companies with ESOPs had a 95% higher net profit margin, 92% higher return on equity, and 24% higher sales growth per employee. They also were 123% more profitable than non-ESOP companies.36 Generally, the tax advantages for ESOPs in the United States exceed those available in the Canada, so these figures might have been even higher had they been measured in the United States. In the United Kingdom, the FTSE also tracks the performance of firms with employee-ownership through its Employee Ownership Index (EOI). Consider the graph below. The purple line shows stock value for companies whose employees hold at least 3% of the firm’s equity. The Y-Axis indicates the stock value per share.

6. In 2009, E. Han Kim and Paige Ouimet at the Ross School of Business at the University of Michigan and the Kenan-Flagler Business School at the University of North Carolina identified a sample of 418 firms with a mean employee-ownership of 16.65%. These ESOPs had a return on equity of 9.1% and a Tobin’s Q of 8.1%. Tobin’s Q is a measure of year-end market value of equity plus the market value of preferred stock plus the total liabilities divided by the book value of total assets. Researchers found that there is a statistically significant positive increase in industry adjusted Tobin’s Q for ESOPs.\footnote{Kim, E. Han, and Paige Ouimet. Employee Capitalism or Corporate Socialism? Broad-Based Employee Stock Ownership. American Finance Association, 25 Mar. 2008. Web. 15 Mar. 2017.}

7. Hamid Mehran of Northwestern University and Hewitt Associates conducted a study on the return on assets of 382 publicly traded companies. The study compared the financial returns of companies for two years before the plan’s implementation and four years after. Firms that
were included in the study had ESOPs that had been in existence for at least 4 years. Mehran found that post-ESOP firms outperformed pre-ESOP firms in nearly every case, with a 1.6% higher return on equity and 6.9% higher return on assets.\textsuperscript{38}

8. Another comprehensive study was conducted by Robert Stretcher and Joseph Kavanaugh of Sam Houston State University, and Steve Henry of the State University of New York. The researchers hypothesized that “…observed performance differences of ESOPs are artifacts of the use of accounting returns influenced by the tax benefits of ESOPs, firm size, industry group, capital structure and risk. When these are controlled for appropriately, no significant differences should exist between ESOP and non-ESOP firms.” They looked at 196 U.S. firms over seven years of performance and used match-pair comparison. They found that in six out of seven years, the ESOP firms had a greater return on assets than did non-ESOP firms. Moreover, beta, which is a measure of a firm’s risk to investors, was higher for non-ESOP companies. One possible explanation for this is that employee-owners tend to be less risk averse than traditional ownership. Employees are innately aware that firms and their own financial interests are intertwined, so they are cautious when engaging in major capital expenditures and acquisitions. To summarize these findings; when compared to similarly situated non-ESOP companies, ESOPs had a 5.5% greater return on equity, a 10% higher net profit margin, a 0.8% decrease in sales and a 0.8% increase in market value over the seven-year period studied.\textsuperscript{39}

9. \textit{Stock Options, Corporate Performance, and Organizational Change} was a survey conducted in 2000 that compared firms that compensated employees with stock to companies that did


not include stock options in their compensation structure. Researchers Joseph Blasi, Douglas Kruse, James Sesil and Maya Kroumova found that companies with stock options had a 5.8% higher Tobin’s Q, a 2.5% higher return on equity, and were 17% more productive. Because stock options tend to reward only the highest paid employees of a firm, whereas broad-based ESOPs put stock in the hands of many employees, this study lies outside the central focus of this paper.40

10. *Firm Survival and Performance in Privately-Held ESOP Companies*, was conducted by Joseph Blasi, Douglas Kruse and Dan Wellman. The researchers constructed the dataset by merging ESOP information from the ESOPs’ ERISA-required public filings of Form 5500 for each year from 1988 to 1999. 343 companies were matched to non-ESOP firms based on their name, city and state. The researchers found that sales growth in the sample of ESOPs were 2.5% higher, that the market value was 2.3% greater and that employment grew at a 2.3% higher rate over the period from 1988 to 1999.41

11. Co-founders of the National Center for Employee Ownership, Corey Rosen and Michael Quarrey conducted a major survey on the effects of employee-ownership at 45 firms between 1982 and 1987. They presented their findings in the September/October issue of the Harvard Business Review. The researchers conducted a longitudinal study that looked at the financial performance of ESOPs five years after the ESOP was created. Their results also supported the conclusion of this thesis. Rosen and Quarrey found that, compared to the period prior to creation of their ESOPS, ESOP-firms had a 17% higher Tobin’s Q, a 11.5% higher return on

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equity, a 5.4% increase in sales growth, a 5% increase in employment growth and a 6.1% increase in wage growth. Their research indicates that after five years, companies with ESOPs generally improved their performance and return to employee-owners as shareholders.42

12. The final study was included to add an alternate perspective on the topic. In most of the studies that were reviewed for the purpose of this report, the researchers found that employee-ownership greatly improved firm performance. However, in a 2005 paper titled, *When Labor Has a Voice in Corporate Governance*, commissioned by the National Bureau of Economic Research (NBER), researchers Olubunmi Faleye, Vikas Mehrotra and Randall Morck found that employee-ownership had an adverse impact on firm performance. They argued that because ESOPs have a nontraditional governance structure, employees are positioned to make major decisions about the company, which may not necessarily be the most informed decisions. These researchers found that ESOP firms had a 9.0% reduced Tobin’s Q and that sales grew at 3% lower rate than non-ESOP firms.43

The findings from each of these studies represent data collected from thousands of ESOPs in the United States. The aggregate of the data provided by these studies is the most effective and appropriate method of testing the research hypothesis, that on average, companies with ESOPs will outperform companies without ESOPs.

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### Data Summary

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Figure 5 Data Findings Summary
Data Analysis
Consider the weighted averages shown below.

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**Figure 6 Annualized Unweighted & Weighted Averages**

The table shows a weighted average of the data collected for this paper. By weighting the averages rather than calculating an arithmetic average, the studies with larger sample sizes are given more value than the studies with smaller sample sizes. Additionally, because some of the studies are longitudinal and others are not, it cannot be said with strict scientific causality that firm performance is driven by the presence of an ESOP alone.\textsuperscript{44} The practice of aggregating data

\textsuperscript{44} “Since not all the studies are longitudinal studies, one cannot establish strict scientific causality on that score. So one cannot be certain in each of the studies that the employee ownership itself is causing this observed improved
without distinguishing how the studies were conducted (pre-ESOP to post-ESOP/ESOP to non-ESOP) is an established practice among noted researchers, including Joseph Blasi and David Kruse. That practice was used in both meta-analyses included in this paper. Furthermore, the number of firms included in some of the studies were not easily ascertained. This means that the weighted averages do not include the studies where the sample size was not found. In sum, the figures above reflect that there is a positive correlation between the presence of an ESOP and firm performance. While this data is promising, it is important to note that further research on ESOPs would be necessary to establish causation between firm performance and the presence of an ESOP. This is because the current analysis is based on only a portion of the total research that has been conducted on the topic. Future researchers will need to conduct a meta-analysis of all ESOP-related studies to establish that the presence of an ESOP at firm will lead to changes in performance.

The data pertaining to the return on equity and wage growth require further analysis. The return on equity figure is the most useful metric for investors analyzing the positive impact of a single security on a portfolio. It is equally important to analyze wage growth. This tells employees that if they create an ESOP, they will likely not need to forego wage increases. The other information would be useful to a person conducting a valuation or attempting to paint a broad picture of the firm’s financial health, but the ultimate purpose of this report is to explain how ESOP ownership effects investors and employees of the firm.

Return on equity can be a revealing figure about the quality of the firm. Based on the research conducted for this report, ESOP firms had a weighted average of 2.8% higher return on performance or whether it is caused by other factors.” See Footnote 26 and 27 (Blasi and Kruse discuss their researcher methodology)
equity than comparable non-ESOP firms. Since its inception, the S&P 500 has historically averaged a 10% return on equity. One implication of these findings is that if companies with ESOPs are as evenly distributed throughout the S&P 500 as they are in the entire U.S. economy, an investor who indexes their portfolio to the S&P would likely observe a smaller return than an investor who placed all their savings in an ESOP account. This is because ESOPs firms outperform non-ESOP firms by 2.8%. Although it is impossible for this to occur because most ESOPs are privately-held, the NYSE or NASDAQ should begin to track employee-owned businesses. The Toronto Stock Exchange in Canada and the FTSE in the United Kingdom both track publicly-traded business with more than minimal employee-ownership. In both cases, employee-owned businesses had a greater return.

Wages are also indicative of the quality of an employee-owned business. In the ideal world, employees will not give up wages for equity. Based on the findings above, the weighted average of wages at ESOP firms is 7.8% higher than non-ESOP companies. This tells us that employees need not be concerned about forfeiting future wages should they establish an ESOP. The eventual purchase of the company’s shares is often financed by the company’s own profits. This means that employees will likely only lose earnings if they were involved in a profit-sharing scheme prior to the establishment of the ESOP. After the ESOP has been paid off, wages will continue to grow as they do at any other productive firm, and employees will have the added benefit of the savings allocated to their ESOP accounts.

There are a variety of limitations inherent in the chosen methodology. First, the study does not consider confidence intervals, variance or the sampling error. Another limitation is that there are potential moderators of the observed effects. This means that a different variable besides the presence of an ESOP could account for the different comparative results.
Another concern related to the methodology is that not all the available statistics from each of the studies were included in this report. This author felt that statistics related to firm culture and non-financial information may distract from the primary purpose of the thesis. However, it is worth mentioning that the researchers did study variables that have not been mentioned, such as firm culture, size and location. Findings suggest the positive effects of ESOPs are promising. However, further research on the effectiveness of ESOPs should be pursued because the current analysis is based on a subset of the entire body of research and statistics available for summary. Future research should undertake a more comprehensive analysis based on a meta-analysis of the entire body of available data before strong conclusions may be drawn. It is also possible that researchers surveyed the same companies, so that their results have been included twice in this thesis’s results.
Conclusion

Public and private efforts to promote broad-based ownership in the United States can be traced back to the Revolutionary Era. President George Washington tasked Thomas Jefferson with devising a way to rescue the failing cod fishing industry. To improve profitability and create incentives for workers, Jefferson devised a policy that provided tax credits to fishing captains who shared their profits with sailors. This is perhaps the earliest example of shared capitalism in the U.S. Over the years, there have been major Congressional campaigns to promote employee-ownership and ESOPs. Senator Russell Long worked diligently with government officials to fund studies identifying the effects of employee-ownership on savings rates and firms. In 1978, Senate staffer, Corey Rosen was the first people to create legislation that promoted employee ownership. Policies that promote ESOPs and other forms for employee-ownership have become increasingly sophisticated and more powerful at creating incentives for firms and their owners.

So, why do ESOPs, on average, outperform non-ESOP firms? The two most compelling answers point to the effects of tax advantages and incentives for employees. The tax advantages go well beyond benefitting departing owners; they can also benefit employees who remain at the firm. When an ESOP is established, the tax benefits, all other things being equal, make the firm inherently more profitable. There is a strong positive correlation between ESOP-friendly tax policy and the inception and profitability of firms in this category. Likewise, the incentives created for employees explain why ESOP-firms are more profitable. Employees who have a

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46 See Footnote 3
stake in the future of a company not only as employees and retirees, but as owners, are likely to work harder and more efficiently. Employees who stay with the company for an extended period are typically granted greater equity distributions than are shorter-term employees. This helps with worker retention and significantly reduces the costs (both economic and opportunity) of having to train new employees.

Researchers generally agree that ESOPs will ultimately lead to greater firm performance, although there is disagreement as to the extent to which this is true. This report compiled and analyzed 12 of the most highly regarded studies in recent years on the topic and found that the average ESOP will generally outperform non-ESOP competitors. Those who dismiss the impact of ESOPs or believe that they should be disbanded often point to historical anomalies such as Enron and Eastern Airlines. While it is true that employee-ownership in these firms had a detrimental effect on workers, it is important to point out that there were major issues relating to the corporate governance and ethical behavior of both firms. If more had been done to protect Enron and Eastern Airlines employees’ rights as investors, naysayers would be deprived of any evidence suggesting that ESOPs are a harmful force for plan participants. Thus, this report calls for greater protection for ESOP participants.

One of the ways that this could be accomplished would be to mandate that employee-owned firms maintain 401(k)s to help diversify each participant’s overall retirement income portfolio. This would eliminate the single-firm risk that arises when employees fail to purchase securities other than that of their own employer. Another way that employees could be better protected would be allow employees to freely liquidate their ESOP account by selling shares to other employees or back to the firm. An advantage of being publicly-traded is that the value of company stock can be readily determined by the market, but most ESOPs are privately-owned.
This means that an independent appraiser will use the firm’s recent sales and profitability to develop future projections and discount them to an accurate present value. By allowing ESOP participants to freely purchase and sell shares to one another or back to the ESOP trust, a certain degree of free market capitalism is introduced into an otherwise rigid and opaque system. Investor sentiment will help to determine the value of the shares if the appraiser determines the company’s value to be much higher or lower than its fundamental value. In the future, ESOP firms should be required to keep capital on hand to pay for stock that employee-owners would like to liquidate. Obviously, there will need to be exceptions to this rule in the case of bankruptcy or a fire sale of the firm’s stock. In either case, it is the appraiser who should be held accountable if their valuation is grossly inaccurate. If appropriate changes are made to protect employee-owners, critics will find it difficult to dispute the positive effects that employee-ownership could have in the future.

The purpose of this thesis was to determine whether employee-ownership can have a meaningful impact on firm performance and the financial well-being of investors. Based on the meta-analysis of past research, it can be confidently stated that ESOP firms, on average, will outperform non-ESOP firms. Thus, the hypothesis is confirmed. If more employees and legislators are educated on the benefits of employee-ownership, ESOPs will become a major economic force in the coming years.
Bibliography (corresponding with footnotes)

6. See Footnote 2
8. See Footnote 2
9. See Footnote 2
13. See Footnote 10
18. See Footnote 17
19. See Footnote 17
20. See Footnote 17
21. See Footnote 17
22. See Footnote 17
31. The market value of a company’s assets divided by the replacement costs of a company’s assets (book value).
44. “Since not all the studies are longitudinal studies, one cannot establish strict scientific causality on that score. So one cannot be certain in each of the studies that the employee ownership itself is causing this observed improved performance or whether it is caused by other factors.” See Footnote 26 and 27 (Blasi and Kruse discuss their research methodology)
45. See Footnote 3

**Figures**
Academic Vitae

Frederick Steimling
FS3599@psu.edu
+1 (570) 765-1204

EDUCATION

The Pennsylvania State University - Schreyer Honors College
School of Labor and Employment Relations
Labor Studies & Employment Relations | Bachelor of Science
Certificates: Collective Bargaining Unions & International Labor Relations

Skills: Excel, Financial Modelling, VBA Programming, QuickBooks, Bloomberg, UCC transactions, Experience Abroad

PROFESSIONAL EXPERIENCE

School of Labor and Employment Relations, Penn State University
Economics Tutor
University Park, PA
Spring 2017 - Present
- Tutored student in groups of 4 times/week to assist with introduction to microeconomics, microeconomics and advanced labor economics
- Reviewed student exam performance with professors and advisors to improve quality of economics courses at PSU

Providence Kov
Enterprise Relations Intern
London, England
May, 2016 - August, 2016
- Provided legal and financial advice to 20+ clients experiencing homelessness and prolonged unemployment in the UK
- Coordinated individual meetings, interviews and workshops with clients and corporate sponsors

Department of Economics, The College of Liberal Arts, Penn State University
Grading Assistant | Advanced Labor Economics
University Park, PA
Spring, 2015
- Graded exams, projects and term papers for a class of 120 students in a team of 3 other assistants
- Assisted with students on team projects involving financial modeling, market trends and the economics of professional sports

LEADERSHIP

Penn State Global Brigades
Business Consultant
State College, PA & Tegucigalpa, Honduras
January, 2014-Present
- Worked closely with banks to provide financial consultation to under-resourced enterprises in Latin America during annual visits
- Raised $30,000 in 2016-2017 to provide accounting & financial support to businesses in developing countries

Beta Theta Pi, National Fraternity - Alpha Upsilon Chapter
Vice President of Finance | Philanthropy Chair
University Park, PA
January, 2014-Present
- Stewardship $150,000 semi-annual to support the philanthropic, operational, and social objectives of the organization
- Weekly meetings with Advisors, University officials and active members to discuss the financial health and performance of the fraternity

Penn State Investment Association
Assistant: Consumer Discretionary & Industrials Sectors
University Park, PA
August, 2013-Present
- Interpreted the impact of global trends on the market portfolio of the Veterinary Line Fund, LLC; a $7.0 MM student-managed investment fund
- Collaborated directly with Fund Managers and banking professionals on investment strategy of the student organization

Club Fitness and Bodybuilding
Treasurer
University Park, PA
August, 2014-Present
- Hosts educational seminars on current trends in the fitness industry; appropriated $2,000 in membership dues to semester as officer

OTHER

Awards: Schreyer Family Scholarship, Paul Huebner Award (Community Service), College of Liberal Arts Enrichment Award; School of Labor and Employment Relations Enrichment Award (Community Service), Phi Kappa Phi Honor Society (Distinction in Liberal Arts), Beta Gamma Sigma Honor Society (Distinction in Business), Navy League Scholarship (Distinction in Military Studies), Donald C. Abbey Scholarship
Languages: Basic Spanish & German