Re-Constituting the Corporation:
ESOPs, the Japanese-type Company, and Other Ways
to make the Employees into Members of their Company

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Abstract
Corporations have evolved with some similarities and some differences in all the industrialized countries—in the
United States and England, in West Europe, in Japan, and now in Korea. But all face similar problems of worsening
"ownership" after the original generation of founders is long gone. "Ownership" has generally become more
absentee and more institutional as shares have become more widespread on public stock markets. In the very
beginning of a firm, the founding owners and the firm as a community were closely identified, but then firms evolve
so that the owners are quite separate from the firm, and the community of the firm is largely ignored as the firm is
treated as an "asset" on the market. This paper argues that large public corporations should be re-constituted so that
absentee investors should be treated largely as investors, not as "owners", and that the people who work in the firm
should be re-constituted as members of the firm. What are the paths from the present situation to such an outcome?
The second part of the paper reviews mainly the American and English experience with Employee Stock Ownership
Plans along with some mention of the Japanese-style firms in keiretsu and the West European (mostly German)
experience with co-determination.
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References
Part I: The Choices Facing Korea

The Two Logics of Institutional Design

Institutions such as corporations and labor relations systems have a certain internal logic. Perhaps for a while they can tolerate all sorts of transplants and hybrid structures but eventually they need to end with a structure that hangs together with some internal coherence. What are the models towards which Korean companies-and-labor-relations\(^1\) might evolve?

One prominent perspective is that there is only one "best" model. All roads lead to the Rome of the American or Anglo-American corporation with shares dispersed on the stock market and with employees being either unorganized with employment-at-will contracts or organized with non-cooperative trade union relationships. Anything else is just an "immature" or "confused" model that eventually must converge to the American model if it is to survive.

I will argue to the contrary that there are actually two overall logics of organizational design which might be called the *logic of exit* and the *logic of commitment*. The two logics have been developed by Albert Hirschman [1970] as exit versus voice, loyalty, and commitment. One of the best treatments of the organizational contrast between the two logics is Kagono and Kobayashi 1994. Each of the two models does not have such tight internal coupling that one must be entirely one or entirely the other. Any actual model will have all the markings of its path-dependent evolution. But I will argue that these two logics are like two basins of attraction; water will eventually flow towards one or the other. Or one might think of the two poles of a magnet with a small piece of iron eventually moving towards one pole or the other.

In contrast to the seemingly dominant "model"\(^2\) of the American company, there are various partial and still evolving models of a commitment-based company that have been historically realized: the companies in the US and UK with majority employee stock ownership plans (ESOPs), the co-determination firms in Germany,\(^3\) the system of Mondragon cooperatives in the Basque region of Spain,\(^4\) and the large Japanese companies with a type of "employee sovereignty".\(^5\)

Korea is now at the crossroads. Should it move towards the American company "model" or should it evolve a Korean variant of the commitment-based company learning what it can from the other historical partial models of that type of firm?

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\(^1\) The structure and culture of a company are so closely related to the system of labor relations that I will take any model of a "company" as including the system of labor relations.

\(^2\) It will be argued below that the model lives mostly in textbooks and lawbooks. Actual American companies have many attributes of the commitment-oriented logic so these companies are pulled in both directions.

\(^3\) See Rogers and Streeck 1994; Backhaus 1999.

\(^4\) See Whyte and Whyte 1991; or the Mondragon website: [http://www.mcc.es/](http://www.mcc.es/).

\(^5\) "The fundamental principle underlying the Japanese model of mixed economy is anthropocentricism, or what Keisuke Itami refers to as "peoplism." Peoplism is given concrete expression in the form of employee sovereignty with the corporation, and an emphasis on the independent, land-owning farmer within agriculture. This principle is clearly different from the ideological foundations of Western capitalism, and it would be incorrect to assume that the Japanese system belongs to the same regime just because it uses market mechanisms extensively and exists side by side with a democratic political system." [Sakakibara 1993, 4]
The Two Logics in General

The two logics of exit or commitment are quite ubiquitous so it will be useful to briefly look at them abstractly and then specialize to the questions of organizational design. Many choices can be parsed in the following way. There are a number of boxes A, B, C, and so forth. Each box has within it something with certain properties or characteristics. You are now in box A and you are unsatisfied. You have two basic strategies. The exit-oriented strategy is to backtrack and exit the box and then try another box such as B or C. This strategy in effect treats the contents of the box with its characteristics as fixed, so the only road to improvement is to exit the box. Alternatively, the commitment-orient strategy is to remain loyal and committed to the "A" branch but to use "voice" to try to improve the characteristics of the contents to box A1 or A2 and so forth. These two strategies can be pictured as two ways to search on the following tree.

![Figure 1: Exit Box A for B or C, or Change Box A to A1 or A2?](image)

Many choices can be parsed in this way. To seek improvement by giving up what you have and trying to replace it with something better—or stick with what you have and try to transform it into something better? Replace or repair? Flight or fight? Does the "unhappy camper" fold his tent and look for a better campsite or does he work to make the given campsite better? Every potential migrant faces the question: exit to find a better home or commit to making home better?

Managers constantly face similar decisions. When a team of workers is not performing satisfactorily, the manager has two choices. One choice is to take the capabilities of the team members as fixed so that people need to be shuffled in and out of the team until the right team characteristics are obtained. Or a manager might proceed with more commitment to the team members and then try to work with them to better develop their capabilities until the team performed satisfactorily.

Exit versus commitment are the two logics that run through the design of institutions. The market is an institution that operates largely on the basis of the logic of exit. Economics developed first as the theory of markets and market behavior so economics tends to see the world through an exit-oriented lens.

The economist tends naturally to think that his mechanism [exit] is far more efficient and is in fact the only one to be taken seriously. [Hirschman 1970, 16]

Organizations (including political units or polities) would seem to be the natural setting for commitment-based strategies. If there are some costs or barriers to exit in the face of
dissatisfaction, then the exercise of voice may be the better way to change things. Hence one might expect to see organizations designed on the basis of the logic of commitment.

**Allocative Efficiency or X-efficiency?**

More broadly, take a box to be a particular use of a resource and take the characteristics to be its productivity or effectiveness in that use. Then the two system logics give two ways to get improved performance and efficiency. The exit-oriented strategy is to move resources to higher-productivity uses (e.g., through the market) and the commitment-oriented strategy is to get higher productivity out of resources in the given use (e.g., in an organization). The exit-oriented notion of efficiency is *allocative efficiency* associated with markets. Resources in a certain use have fixed productivity so it is a question of the allocation of resources to the higher-valued uses. The commitment-oriented notion of efficiency is *X-efficiency* [Leibenstein 1966; 1984] where the principal variable productivity of a resource in a given use (e.g., in an organization) is human effort.\(^6\)

If a skill is quite standardized and available on the market, then a firm might use a exit-oriented low-commitment system. The low-trust system is self-reinforcing in its system logic. Low trust leads to highly explicit contracts with competitive arms-length relationships with no need to invest in building trust or loyalty, and thus the low-trust environment is reproduced.

But the logic plays out differently when the jobs require more firm-specific skills and where the quality of effort is not only variable but largely hidden. If there was little mutual commitment between the staff and the management, then the staff would have little reason to put forth hidden effort and little incentive to invest time and effort in acquiring firm-specific skills. And management would have little incentive in upgrading staff skills that are not firm-specific since the staff might then solicit and accept an offer from another firm that would not need to repeat the training. In firms where firm-specific "human capital" and quality effort are important, the human relations system will tend towards a commitment-based logic [see Blair 1995]. A labor union can be a positive contributor to such a human relations strategy [see Freeman and Medoff 1984]. High trust relationships allow more incomplete relational contracts which require investment in building trust and loyalty so that the high trust environment will be reproduced.

Since low-trust exit-oriented relationships and high-trust commitment-oriented relationships each tend to be self-reinforcing, there are two organizational equilibria. For instance, in Douglas McGregor's management theory [1960], the two equilibria based on the two logics are "Theory X" and "Theory Y." In labor-management circles, the two strategies are often called "low road" and "high road."

There is also a motivational aspect to these two logics. The exit-oriented logic emphasized in economics goes along with extrinsic pecuniary motivation. But most organizations sponsor another type of motivation where the individual "identifies" with the product and the

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\(^6\) Notice that the exercise of voice now appears as the exercise or calling forth of effort broadly interpreted. Although the X-efficiency terminology was developed later, Hirschman has emphasized the importance of the alternative notion of efficiency in economic development: "development depends not so much on finding optimal combinations for given resources and factors of production as on calling forth and enlisting for development purposes resources and abilities that are hidden, scattered, or badly utilized." [1958, 5]
organization, and also where the management shows that it "identifies" with the company staff (all of which might be seen as an "implicit contract" between management and the workers). That is motivational side of the internal commitment-oriented logic in the organization.

In the literature of economics, Herbert Simon has perhaps done the most to emphasize the inadequacy of exit-based reasoning and pecuniary motivation (i.e., neoclassical economics) to account for organizational behavior.

A department will be less likely to skimp on quality to cut costs if its members identify with the final product. In particular, identification becomes an important means for removing or reducing those inefficiencies that are labeled by the terms "moral hazard" and "opportunism." [Simon 1991, 41]

Organizations are so important in modern economies and neoclassical economics is so one-sided in its focus on the exit-oriented market logic that Simon considers the theory to be quite incomplete.

The economies of modern industrialized society can more appropriately be labeled organizational economies than market economies. Thus, even market-driven capitalist economies need a theory of organizations as much as they need a theory of markets. The attempts of the new institutional economics to explain organizational behavior solely in terms of agency, asymmetric information, transaction costs, opportunism, and other concepts drawn from neo-classical economics ignore key organizational mechanisms like authority, identification, and coordination, and hence are seriously incomplete. [Simon 1991, 42]

The Modern Widely-Held American Company
If the exit logic fits markets and the commitment logic fits organizations, then what would an organization look like if it was based on the logic of exit? This brings us to the "model" of the widely-held American corporation. To apply the exit logic, there is one complication. Who's in and who's out? Who are the members of the organization?

There are actually "two companies": the company as a legal entity and the company as a working group of human beings. The legal entity, the legal or de jure firm, has the shareholders as the members. But the members of the actual or de facto firm are the managers and workers who actually carry out the company's business.7 In a small closely-held company, the de jure firm and the de facto firm are largely the same. But for the large modern publicly traded American company, there is very little overlap between the de jure firm (shareholders) and the de facto firm (employees including managers). Those who are actually inside the company (the staff) are from the legal viewpoint outside the firm and have only a market relationship (employment) to the firm. Those who are legally inside the company (the legal members of the company) are the

7 For instance, in the management literature this is closely related to W. Richard Scott's [1998] distinction between a corporation as a "rational system" and as a "natural system."
far-flung shareholders who typically have no business relationship with the company aside from the share ownership.

Figure 2: The Two Companies in a Publicly traded American "Company"

The commitment-orient logic of organizational design would be appropriate for a company, but the problem is that there are the two companies. The commitment-orient design is applied, at best, to the de jure company. The shareholders are seen as the insiders, principals, members, and owners of the (de jure) company. When things are not going well, the shareholders are legally empowered to change "their company." And since the people who actually work in the company, the de facto company, are seen legally as having only a market relationship to the company (the employment relation), their role is modeled on an exit-based logic.

In the Anglo-American economies, starting from closely-held firms (with little divergence between the de jure and de facto firms) the growth of the public market in equity shares has created these rather odd chimeras. And as the de jure firm ("ownership") has diverged more and more from the actual firm, the legal theory broke down. The transaction costs for dissatisfied far-flung shareholders to organize and actually change things were very high. And the returns from organizing enough shareholders would be shared by all shareholders, so there was also a strong collective action problem. Hence shareholders used the "Wall Street Rule"; if you don't like the way things are going, exit by selling your shares.

Hence the people legally empowered to implement a commitment-based strategy ("change things") use a de facto exit-based strategy (sell). And the managers and workers who are de facto in a position to implement a commitment-oriented strategy ("change things") are seen legally as being outsiders ("employees") on the other end of a market relationship with the company. They are not the principals or owners directly empowered by corporate law to change things—so in the eyes of the law, their only option is to quit ("exit") if they are dissatisfied (love it or leave it). Any attempt of workers to organize in unions is seen as antithetical to the exit-based logic of competitive markets. The union is seen as the party on the other side of a contract with the company, not as a part of the internal governance structure of a company. Any attempt of the workers, the members of the de facto firm, to formalize powers to directly "change things" is seen as infringing on the "management rights" exercised by the supposed agents of the far-flung shareholders who are the legal members of the company.
Of course, this bizarre structure would not actually work. Some insiders gladly grabbed the levers of actual control dropped by the shareholders. Those insiders are the top managers, so we arrive at what Adolf Berle and Gardner Means called the "separation of ownership and control" [1932, 89] and at what is currently called the "corporate governance problem." The legal theory or "model" is shareholder capitalism; the underlying actuality is managerial capitalism.8

And from the motivational viewpoint, the bizarre model structure would not work unless those who are legally outsiders on the other end of the employment contract—getting only the economic reward of salary or wage—were to a significant degree committed to and identified with the company. Although this is almost entirely ignored by conventional exit-oriented economics, Economics Nobel-laureate Herbert Simon has emphasized the point.

Organizations would be far less effective systems than they actually are if such economic rewards were the only means, or even the principal means, of motivation available. In fact, observation of behavior in organizations reveals other powerful motivations that induce employees to accept organizational goals and authority as bases for their actions. We turn next to the most important of these mechanisms: organizational identification. [Simon 1991, 34]

Hence the members of the de facto company do in fact tend to identify with the company even though they are legally outside the company!

The large American firm is actually a rather odd and incoherent organization. Those who are legally inside the firm (shareholders) act as if they were outside, and those who are legally outside the firm (employees) act as if they were inside.

This mismatch between the model and reality leaves the analyst in a quandary. Should one analyze the rather mythical company model as it exists in the law and in the economics textbook? That is the "American model" broadcast to the world by ivory tower academics who might think that American companies actually work that way. But since actual organizations need a healthy dose of commitment-oriented behavior to work well, the archetypical exit-oriented "American model" is a textbook model only. The actual large widely-held American companies use a version of the logic of commitment. But the top managers who assume and exercise the legal rights of the insiders (owners) often try to treat all the other employees as outsiders on an exit-based model (e.g., in the labor relations system). Hence the actual large widely-held American firm ends up being something of a contested battleground between the two logics.

In any case, for analytical purposes we will juxtapose two rather pure models, a firm organized on an exit-based model and a firm organized on a commitment-based model.

8 Since there is no legal legitimation for the actual system, the public relations machinery in the companies, in the business press, and in academia broadcasts the goal of "maximizing shareholder value" while the managers show their actual goals in their salaries, benefits, perquisites, (manipulated) stock options, and golden parachutes.
The Modern Japanese Company

In their introduction to a book of essays by Japanese authors about the Japanese-style firm, Ronald Dore and Hugh Whittaker echo Herbert Simon at least about the Japanese case: "Most of the authors would agree that if you want to understand what goes on in Japanese boardrooms, you can throw most of the writings that go under the rubric 'agency theory' out of the window." [1994, 3]

In the post-war era, the large Japanese firms have perhaps gone the furthest to develop the organizational logic of commitment and to contrast it with the logic of exit. For instance, to one trained to think in terms of the logic of exit, any immobilities, rigidities, or barriers to exit would just seem inefficient and irrational. But Japanese economists have evoked the example of useful barriers to exit as in the practice of a captain being expected to go down with his ship.

The way in which underpayment of wages in the early years of service and the acquisition of firm-specific skills create barriers to exit is obvious. These exit barriers perform several important functions for the firm as an organizational entity. The first is the incentive function whereby the interests of the firm and the interests of the individual are linked. Unable easily to exit, people can only protect their interests by working to ensure that the firm prospers. ... The interlinking of interests means that when crisis looms, efforts are redoubled. The option of leaving the sinking ship is not freely available, either to the crew or the captain. [Kagono and Kobayashi 1994, 94]

Barriers to exit can enhance identification and effort. A simple cooperative action game (of the prisoner’s dilemma variety) can be used to illustrate the difference between a company based on low trust with individual optimization and a company based on high trust, identification with the firm, and a cooperative corporate culture [see Leibenstein 1984 for the best treatment of this approach to the Japanese firm]. The players A and B could be thought of as managers and workers (or as any two groups in the firm) who need to cooperate together to increase the X-efficiency of the firm.

<table>
<thead>
<tr>
<th>Payoff to Player A, B</th>
<th>Cooperate</th>
<th>Not Cooperate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cooperate</td>
<td>$A+1, $B+1</td>
<td>$A-2, $B+2</td>
</tr>
<tr>
<td>Not Cooperate</td>
<td>$A+2, $B-2</td>
<td>$A, $B</td>
</tr>
</tbody>
</table>

Table 1: Typical Cooperative Action Game

If each player chooses the individualistic not-cooperate action, then they receive the non-cooperative payoff of $A and $B. If they cooperate, then the total results increases by (say) 2 which we assume is evenly split to arrive at the cooperative payoffs of $A+1 and $B+1. But if one party opportunistically chooses the individualistic non-cooperative option when the other party acts cooperatively, then the total result remains the same (no increase without cooperation.

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9 The efficiency wage hypothesis is that firms will pay more than the going wage for a standard type of work so that workers will have something to lose if found to be shirking. See Akerlof and Yellen 1986.
of parties) and two units are shifted to the opportunistic party. The strategy pair (Not Cooperate, Not Cooperate) is the dominant equilibrium solution. No matter which strategy one player chooses, it will always pay the other player to take the non-cooperative action. But that non-cooperative outcome ($A, $B) is dominated by the cooperative outcome ($A+1, $B+1) which is better for both parties.

This prisoner's dilemma-type game is a generic representation of the countless cooperative action situations that occur continuously and at every level in the complex multi-person productive operation of a firm. In each well-defined and monitored situation, effective enforcement might be applied at a certain cost to change the payoffs and thus assure the cooperative outcome. But this "external" neoclassical solution is hardly feasible over the countless cooperative action situations that occur in a complex team operation.

The question is not whether free riders exist—much less employees who exert something less than their maximum—but why there is anything besides free-riding. Why do many workers, perhaps most, exert more than minimally enforceable effort? Why do employees identity with organizational goals at all? [Simon 1991, 34]

That question is left unanswered in the exit-based American-style model. The Japanese-style company uses the alternative "internal" solution of developing a corporate culture of mutual commitment and cooperation that leads to a virtuous circle or high level self-reinforcing equilibrium. This cooperative culture is feasible because the managers and workers see themselves as the members of a commitment-based community and will reap the joint fruits of their cooperative efforts.

Without promoting stereotypes of American-style or Japanese-style firms, we can still summarize and compare in the following table some of the ways that the two logics affect firm structure.10

<table>
<thead>
<tr>
<th>Table 2: Two Firms</th>
<th>Firm based on Logic of Exit</th>
<th>Firm based on Logic of Commitment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Efficiency</td>
<td>Allocative efficiency: moving resources to the use with the best return (high mobility)</td>
<td>X-efficiency: getting the best return from resources in the given uses. (low mobility)</td>
</tr>
<tr>
<td>Change Strategy</td>
<td>Replace what you have with something better. Problem is to improve choice among options with fixed characteristics.</td>
<td>Transform what you have into something better. Problem is the transformation of given option to improve its characteristics.</td>
</tr>
<tr>
<td>Source of flexibility and change</td>
<td>Exit (change takes place through entry and exit from the organization). Rather flight than fight. Error leads to replacement.</td>
<td>Voice (change takes place by transformation within organization). Rather fight than flight. Error leads to learning.</td>
</tr>
</tbody>
</table>

10 See Clark 1979 or Dore 1987 for similar tables.
<table>
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<th>Firm based on Logic of Commitment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Labor mobility</td>
<td>High mobility so changes take place primarily by hiring workers embodying new knowledge.</td>
<td>Low mobility so changes take place primarily by workers learning new knowledge and skills.</td>
</tr>
<tr>
<td>Contractual relationships</td>
<td>Arms-length.</td>
<td>Relational.</td>
</tr>
<tr>
<td>Role of management</td>
<td>Agents of shareholders.</td>
<td>Senior leaders of community.</td>
</tr>
<tr>
<td>Role of company board</td>
<td>Representatives of shareholders.</td>
<td>Council of community elders with representatives of major related organizations (e.g., main bank).</td>
</tr>
<tr>
<td>Role of shareholders</td>
<td>Absentee investors.</td>
<td>One of stakeholder groups along with suppliers and customers.</td>
</tr>
<tr>
<td>Shareholder interest</td>
<td>Maximization of company profit (assumption that shareholders are normally unrelated to company).</td>
<td>Shareholding often representative of business relationships, the latter being the primary economic interest. Little attention to unrelated floating shareholders.</td>
</tr>
<tr>
<td>Transactions with related shareholders</td>
<td>To be controlled by independent directors or forbidden by &quot;firewall&quot; regulations.</td>
<td>Normal part of relational contracting where shareholding is symbolic of business relationship (called &quot;cronyism&quot; by critics).</td>
</tr>
<tr>
<td>Model of supplier relationships</td>
<td>Competition between standardized producers with feedback through the market.</td>
<td>Cooperation with a small number of suppliers to continuously improve product through non-market feedback.</td>
</tr>
<tr>
<td>Relations to suppliers and customers</td>
<td>Auction market contracting based on assumption of mobility and exit leading to greater allocative efficiency.</td>
<td>Relational contracting based on assumption of immobility and voice leading to greater X-efficiency.</td>
</tr>
<tr>
<td>Stability in relationships</td>
<td>Low trust relationships ⇒ highly explicit contracts with competitive arms-length exit-oriented relationships so no need to invest in building trust ⇒ low trust relationships.</td>
<td>High trust relationships ⇒ incomplete relational contracts with voice-oriented relationships requiring investment in building trust ⇒ high trust relationships.</td>
</tr>
<tr>
<td>Style of interpersonal relationships</td>
<td>Standardized, professionalized behavior as a means of coordinating people. Low interpersonal knowledge associated with high turnover.</td>
<td>Familiarity, intimacy in long-term relationships as means of coordinating people. High interpersonal knowledge associated with low turnover.</td>
</tr>
<tr>
<td>Labor training</td>
<td>Responsibility of worker as it increases value on labor market.</td>
<td>Responsibility of company since immobility allows company to benefit.</td>
</tr>
<tr>
<td>Job definition</td>
<td>Extensively specified job definition to limit opportunism since there is little commitment.</td>
<td>Job flexibility and low monitoring based on worker commitment to company.</td>
</tr>
</tbody>
</table>
| Wage determination | Rate for job determined by market. Payment attached to job. Equal pay for equal work. | Rate determined by seniority and assessed merit. Payment attached to person. Under going-rate at
<table>
<thead>
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</tr>
</thead>
<tbody>
<tr>
<td>Beginning and over it at end as an incentive to stay.</td>
<td>Members expected to identify with firm and shared interest (cooperative strategy).</td>
<td></td>
</tr>
<tr>
<td>Worker motivation</td>
<td>Individual pecuniary self-interest (non-cooperative strategy).</td>
<td>Members expected to identify with firm and shared interest (cooperative strategy).</td>
</tr>
<tr>
<td>Organized worker representation</td>
<td>Trade union (adversary relation based on workers versus company)—my jam or your jam.</td>
<td>Enterprise union (oppositional relation loyal to company)—our jam today or our jam tomorrow.</td>
</tr>
<tr>
<td>Response to decline</td>
<td>Reduce employment and other direct costs to maintain profits.</td>
<td>Maintain employment, reduce hours, and retrain workers for new product lines.</td>
</tr>
</tbody>
</table>

**Ownership for Liquidity or for Enterprise?**

Perhaps the last line of Table 2 requires some explanation. We can distill this wisdom from the academic scribblings of the defunct economist, John Maynard Keynes. Lord Keynes was much concerned with the adverse effects of the stock exchange on real investment and enterprise. Investment in productive enterprise is largely irrevocable, and the management of enterprise requires a long term commitment and the application of "intelligence to defeat the forces of time and ignorance of the future...." [Keynes 1936, 157]11 In short, it is based on the logic of loyalty and commitment. But when investment is securitized as a marketable asset on the stock exchange, then it "is as though a farmer, having tapped his barometer after breakfast, could decide to remove his capital from the farming business between 10 and 11 in the morning and reconsider whether he should return to it later in the week." [Keynes 1936, 151] The stock exchange panders to the "fetish of liquidity" and thus continually undermines the bonds of long-term commitment that are so important to problem-solving and productive enterprise. Keynes, of course, wrote this long before today's problems with stock options and short-termism.

Today's practice of the captain's exit lubricated by a golden parachute is the opposite of the practice of the captain going down with the ship (or falling on his sword).

In addition to this continual erosive effect, the stock exchange also absorbs otherwise productive capital in the function of speculation—which Keynes defined as "the activity of forecasting the psychology of the market."[158] Keynes saw no problem when speculation was but a bubble on the stream of enterprise, but it was quite another matter "when enterprise becomes a bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done." [159] This is even more true when the casino is global rather than national.

Today, Keynes' "stock exchange" must be updated to the global market for bonds, stocks, and currencies. The dangers to investment in enterprise that Keynes highlighted during his day are even greater in our own. Yet Keynes recognized that there is no simple answer in making

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11 In the same vein, Hirschman refers to "that 'long confrontation between man and a situation' (Camus) so fruitful for the achievement of genuine progress in problem-solving." [Hirschman 1973, 240]
investment illiquid as "this might seriously impede new investment...." Few will enter if the door locks behind them. "This is the dilemma." [160] But since investors on today's public capital markets are not enterprisers, the solution lies in the direction of converting equity shares into variable income debt-like instruments that are still liquid.

**Another Look at the Choices**

Since the American "model" is essentially only a textbook and lawbook model, to what extent is it really a possible option? In the American model, the employees have the legal role as the outside suppliers of an input—but in fact they are the firm as an organization of people. This leads to a remarkable schizophrenia of the "two companies." There is the firm in the eyes of the law whose members are the shareholders scattered far and wide, and who typically trade into the stock simply as an investment without any intent or capacity to play a human role in the firm. This is the firm that has a "meeting" once a year. In contrast to this de jure firm, there is the de facto firm consisting of the people who work in the firm—who have a meeting every working day to actual produce the product and conduct the business of the firm.

The large widely-held American company actually *works* because most of those who are legally inside realize that they are really outside and act like it (absentee shareholders using logic of exit), and most of those who are legally outside the company act like they are inside it (employees identifying with the company). Thus the actual American-style company is torn between the two logics, and tends to work well only when it ignores the exit-oriented design logic and uses the logic of commitment. While this type of company is extremely beneficial to the class of top managers, it is not clear how such an incoherent structure torn between the two logics could be recommended more broadly in Korea or elsewhere.

In the previous figure 2, the two companies were presented as a Venn diagram of two overlapping circles. There are four areas, the two parts in one circle but not the other, the overlap, and the area outside both circles. These four areas can also be represented in the following 2 X 2 table of the parties in or out of the legal (de jure) firm and in or out of the de facto firm.

**Table 3: Who's In and Who's Out of the Two Companies**

<table>
<thead>
<tr>
<th>Inside legal company</th>
<th>Outside de facto company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inside de facto company</td>
<td>Shareholders working in company</td>
</tr>
<tr>
<td>Outside legal company</td>
<td>Employees of company</td>
</tr>
</tbody>
</table>

Ordinary consciousness often reflects the de facto company. The employees are often thought of as the members of the organization. Consider the following from a perfectly standard managerial accounting textbook.

An organization can be defined as a group of people united together for some common purpose. A bank providing financial services is an organization, as is a university providing educational services, and the General Electric Company.
producing appliances and other products. An organization consists of people, not physical assets. Thus, a bank building is not an organization; rather, the organization consists of the people who work in the bank and who are bound together for the common purpose of providing financial services to a community. [Garrison 1979, 2]

Garrison is talking entirely about the de facto company, not the company as it exists in law. Look at the books on the business shelves in your local book store. Find a book that uses some expression like "members" of the company. Chances are that the author, like Garrison above, is referring to the employees (including managers) of the firm, not the far-flung shareholders (who are the legal "members").

As Anglo-American stock markets have spread shares far and wide, the idea that the stockholders are in any real sense the "owners" or "members" of a publicly traded company has become a sheer fantasy. There are several groups invested in keeping the fantasy alive. Many economists and lawyers have acquired their professional competence in mastering the legal model and the economic logic of exit behind it. Anything else falls short of the One Best Model. And there are the top managers who have mightily profited from the eclipse of the shareholders. They have every interest in keeping the fantasy of "shareholder capitalism" alive as the cover-story for the reality of managerial capitalism—much as the nomenklatura of the Communist Party had every interest in keeping the fantasy of "People's Democracy" alive.

Concluding Remarks on Part I
What Berle and Means described as the "separation of ownership and control," John Maynard Keynes described as the "euthanasia of the rentier, of the functionless investor" [1936, 376] caused by the public equity markets. This separation of ownership and control along with the unaccountability of managers and the resulting abuses has created the "corporate governance problem." Who is to be the new legitimate members of the company? While a few wistfully hope for the resurrection of "responsible private owners" in the form of massive institutional investors run by portfolio-managing bureaucrats, others search the horizon for various "stakeholders" who together with the regulatory agencies and law courts might create a "new accountability." But they are searching for legitimacy in all the wrong places.

There already is a class of members who make up the firm, the de facto firm consisting of the people who work in it. In a company designed on the basis of the logic of commitment, they would be the legal members of the company. And since they are the de facto firm, the staff of a company are the ones who could actually monitor the management of their company and address the corporate governance problem directly.

The only cohesive, workable, and effective constituency within view is the corporation's work force. [Flynn 1973, 106]

And there already is a legitimacy norm for questions of governance, democracy. The notion of "shareholders' democracy" is not only impractical but is incoherent since the shareholders are not themselves under the authority of the managers.
The analogy between state and corporation has been congenial to American lawmakers, legislative and judicial. The shareholders were the electorate, the directors the legislature, enacting general policies and committing them to the officers for execution. …

Shareholder democracy, so-called, is misconceived because the shareholders are not the governed of the corporation whose consent must be sought. [Chayes 1966, 39-40]

Many parties have their interests affected by a company and better judicial and regulatory means are needed to protect those legitimate outside interests. But those (de fact and de jure) outside parties are not governed or under the authority of company management. Only the de facto firm, the people working in a company are under the authority of the management within in the scope of the work. Hence the path to democracy in the workplace is to redefine the de jure firm so that it matched the de facto firm (which would eliminate the off-diagonal elements in table 3 above).

Here is the most urgent challenge to political invention ever offered to the jurist and the statesman. The human association which in fact produces and distributes wealth, the association of workmen, managers, technicians and directors, is not an association recognised by the law. The association which the law does recognise—the association of shareholders, creditors and directors—is incapable of production and is not expected by the law to perform these functions. We have to give law to the real association and withdraw meaningless privilege from the imaginary one. [Percy 1944, 38; quoted in Goyder 1961, 57]

This is a process of reconstituting the corporation. All the work towards greater participation of workers in the affairs of their company points in this direction. In some respects, the psychological transformation is already there; the real members of a company as seen as the people who actually are the de facto company. What remains is the legal transformation, the withdrawing of privilege from the imaginary company of shareholders and the legal recognition of the actual members of the company.
Part II: Rethinking the ESOP in Korea

Introduction
In this part II, I focus on the ESOP path to making the employees into members of the company. Other paths should also be considered such as German co-determination and the Japanese corporate culture of "employee sovereignty" but our focus here is ESOPs. The title of this part II, "Rethinking the ESOP in Korea," has three meanings.

Firstly, I want to suggest rethinking what is called an "ESOP" in Korean (a certain type of stock purchase plan) and moving more towards allowing the type of transactions that characterize the Employee Stock Ownership Plans in the United States or the United Kingdom.

Secondly, I want to suggest that the legal structure of the ESOP should be made part of the company through changes in a standard fashion in the companies charter and bylaws rather than having the ESOP organized using an external trust or other legal entity.

Thirdly, I want to suggest that the reasoning behind the ESOP should be rethought as admitting workers into a new category of membership in the company rather than as a type of co-ownership so that each ESOP company would then have its shares divided into two parts: the external members such as the traditional shareholders and the internal members which would be the long-term employees of the company.

Broadly speaking, the phrase "ESOP" has come to mean any of a variety of programs to increase employee shareholding in their company. The goals are broadly the same across countries; to strike a new bargain between the traditional shareholders and the employees of the company to improve productivity, to further employee identification with the company, to stabilize the ownership of the company, to stabilize employment in the company (and thus to foster more technical change but without job loss), and to improve the distribution of income.

The Korean ESOP which dates from 1974 (with changes made in 1987) is an initial step on a road that branches in several directions. It is essentially an employee share purchase program where the employees pay for the shares individually but with discounted prices and sometimes with special loans to finance the purchases.12

The ESOP as it has evolved in the United States (and the United Kingdom) represents a next step along one path. It represents more of a new collective bargain between the company and the employees, not individual share purchase decisions. Often in return for certain concessions from the employees, the company will set up an ESOP and will also typically raise certain new finance "through the ESOP" making it a "leveraged ESOP." In one form of the transaction, the loan money is used to buy newly issued shares from the company for the current and future employees. But a big difference from the individual share purchase plans is that company pays off the loan as a type of benefit or pension-like contribution for the employees. As the loan is paid off, a proportionate part of the purchased shares are allocated to all the employee share accounts in the separate ESOP trust in proportion to the labor compensation of the employees.

Two other paths of increasing employee involvement and identification with the firm might be mentioned. In Germany and now in a number of other EU members that is a form of codetermination where employees are directly represented in a works council which has a role in the internal governance of the firm. The strength of this path is that workers directly qualify as workers to play a role in the governance of the firm but a weakness is that there is no financial component to the participation. In Japan, there is another path to make the long-term workers into a type of member in the large firms. The external shareholders are not seen as the "owners" and the company is viewed more as a community than a piece of property (although the shares are still pieces of property on the stock market). Here a weakness is the lack of explicit legal structure; the transformation is effected more through the culture and community norms of the company.

I will focus on some of the features of the American ESOP as possible next steps for the Korean ESOP and then I will turn to seeing how it could go further to legally implement some of the features of the large Japanese companies.

**American Employee Stock Ownership Plans (ESOPs)**

In the United States, an ESOP is a special type of benefit plan authorized by the Employee Retirement Income Security Act (ERISA) of 1974. As in any employee benefit plan, the employer contributions to an ESOP trust are deductible from taxable corporate income. But, unlike an ordinary pension trust, an ESOP can take out a loan to buy shares and can invest most or all of its assets in the employer’s stock. This makes an ESOP into a new vehicle for worker ownership but it is not a substitute for a diversified pension plan.

ESOPs have received strong tax preferences so for that reason, if for no other, their growth has been significant. From the beginning in 1974, 11,000 ESOPs sprung up in the United States covering over 10 per cent of the workforce (in comparison, a comparable or smaller per cent of the workforce is unionized). There are over 1000 ESOPs holding a majority of the shares in the company. The main tax advantage to the company is the ability to deduct the value of shares issued to an ESOP from the taxable corporate income.

**Structure of ESOP Transactions**

The simplest role of an ESOP is what would be called the "unleveraged ESOP." This is essentially a profit-sharing plan where the profits distributed are directly in the form of stock or in the form of money used to purchase stock. The corporate employer adopts an employee stock ownership plan (ESOP) which includes a trust as a separate legal entity formed to hold employer stock. The company gets a tax deduction for the value of the profits shared with the ESOP. As with any American ESOP, the workers do not pay individually for the shares. The quid pro quo is a broader exchange of more productivity, more concessions, or more commitment to the firm.

![Figure 3: Unleveraged ESOP](image-url)
In a leveraged ESOP transaction, the ESOP borrows money from a bank or other lender (step 1 in diagram below), and uses that money to purchase some employer stock at fair market value (steps 2 and 3). There are two cases according to whether the stock is newly issued or is purchased from a previous external owner. First we consider the case of newly issued shares. The loan proceeds thus pass through the trust to the employer, and the new stock is held in the trust. Ordinarily, the company guarantees repayment of the loan by the ESOP and the stock in the trust is pledged to guarantee the loan.

Over time, the employer makes contributions of cash to the ESOP in amounts needed to repay the principal and interest of the bank loan (step 4) and the trust passes the payments through to the bank (step 5). Thus, the employer pays off the loan gradually by repayments to the lender through the ESOP—payments that are deductible from taxable income as deferred labor compensation. This deduction of both interest and principal payments represents a significant tax advantage since the employer ordinarily can deduct only the interest payments. Prior to the loan payments, the shares in the ESOP are held in a “collective” Suspense Account. As the loan payments are made, a proportionate amount of the shares are assigned to the individual share accounts of the then-current employees. Thus the ownership benefits accrue to the then current employees even if they joined the company after the original ESOP loan was made. In the meantime, the shares were held in the “suspense account” to insure that they would go to the employees who work in the company as it makes each loan payment.

![Diagram of a Standard Leveraged ESOP](image)

**Figure 4: A Standard Leveraged ESOP**

An ESOP can also be used to partially or wholly buy out a company from a previous private or public owner. This is called the “leveraged buyout transaction.” The ESOP borrows money (step 1 in diagram below) and the loan payments are guaranteed by the firm with the purchased shares as collateral. The shares are then purchased from the outside owner, such as the government, with the loan proceeds (steps 2 and 3)—instead of buying newly issued shares from the company.
Figure 5: Leveraged Worker Buy-Out from Outside Seller (old shares)

Again the firm makes ESOP contributions which are passed through to pay off the loan (steps 4 and 5). A variation on this plan is for the seller to supply all or some of the credit. By combining the functions of the bank and outside seller in the above diagram, we have the “pure credit” leveraged buyout transaction.

Transplanting ESOPs

Sometimes the acronym "ESOP" is used to refer to most any employee ownership arrangement. But that broad use of the phrase is likely to overlook some important innovations in the ESOP design. I will focus on four important innovations worthy of being preserved in any "ESOP" arrangement for other countries and one innovation not used because of the way ESOPs were legislatively implemented in the United States.

1. Payments for worker shares are company payments coming out of revenues, not directly out of workers’ pockets. Then the worker ownership needs to supplemented by workplace participation and productivity improvement programs so that the shares will, in effect, be paid for by the increased productivity. There are nevertheless good psychological reasons to have each worker make some significant out-of-pocket payments even though this is not required in the American ESOPs.

2. The ESOP is a stable form of employee ownership. The workers cannot individually sell their shares at any time (the company usually buys back the shares when the worker leaves or retires). With stabilized ownership, workers will focus on getting more value out of their ownership by making the company more profitable rather than constantly looking around for sharp share-selling deals. Thus this type of share ownership is quite different from ordinary ownership of shares on the stock market as a speculative investment.

3. ESOPs have broad-based ownership within the firm. As the ESOP loans are paid off, the shares are allocated according to payroll to the current employees. Thus ownership is automatically going to the primary stakeholder group (the people working in the firm) and it is going to everyone in the group, not just to a small group of managers (e.g., as with most stock options plans).
4. ESOPs have an available transition mechanism so that as the old workers retire and new workers come in, the ownership shifts from the older to the younger generation. As workers retire or otherwise leave, company contributions to the ESOP trust are passed through to buy back the retirees shares at their appraised value over a period of years and the shares repurchased by the trust are reallocated to the currently employed workers.

In the American ESOP, the share buybacks are timed to retirement or termination because the legislation was implemented as a part of pension law. However in new ESOP legislation in other countries, one could imagine an improved arrangement so that risk did not accumulate for the older workers. For instance, one could have all shares repurchased and reallocated after they have been in a worker's account for, say, seven years. This seven-year rollover plan would then take the pressure off retiring in order to cash in shares. Everyone, retired or not, would get a flow of share buyback payments seven years after the shares first went into their accounts. From the company's viewpoint, the repurchase liability would not be a random event triggered by retirements but would be known seven years in advance.

**External and Internal ESOPs**

One major feature of the American ESOP that proves not to be necessary in different legal environments is the external trust as a vehicle for the ESOP. The ESOP can be moved into the company itself to form an “internal ESOP”. As is illustrated by professional partnerships or worker cooperatives ("share cooperatives"), an enterprise or organization can be employee owned without having an external trust or association to “hold the ownership.” The structure of the internal ESOP can be written into the articles of incorporation and by-laws of the company itself. The idea is to move in the direction of thinking of the employees as a built-in part of the governance structure of a company, not as an organized external group of shareholders operating through an external trust or employee ownership association. The discussions between the managers and the employees as owner/members should be day-to-day on-going discussions, not an occasional talk at board meetings or the annual meeting of shareholders. The internalization of the ESOP moves in that direction.

**Figure 6: Bringing an ESOP inside a Company**

The equity of the firm with an internal ESOP could be partitioned into the usual external equity and the workers’ portion of the equity structured as the internal ESOP, or in more generic terms, an internal worker trust.
Figure 7: Balance Sheet of Firm with Internal ESOP

With an internal ESOP, the authorized and issued common voting shares would be divided into the externally owned shares (i.e., shares owned outside the “ESOP” by individuals or organizations) and the internal shares held in the worker trust. The basic division of voting rights and dividend rights between the ESOP and the other owners would follow that division of shares.

The ESOP agreements and trust documents would be replaced by sections in the articles of incorporation (the “constitution” of the firm) and the corporate by-laws that would spell out the structure and governance of the internal ESOP. It is important that the external shareholders not have right to overturn the ESOP arrangements. Thus this internal ESOP can be implemented in any country that has joint stock company law. If the ESOP was to have tax benefits, then the tax legislation would have to recognize some standard form of the external or internal ESOP arrangement for special treatment.

The High Road Commitment-Oriented Strategy

All the discussion about ESOP details misses the bigger question of what is the purpose of any ESOP-like structure. The Korean industrial relations system is at a fork in the road about how it will respond to the challenges of globalization. In general terms, it is a decision between a high road commitment-oriented strategy roughly along the lines of the Japanese strategy, and a low road exit-oriented strategy of the American model.

In the commitment-oriented strategy, a fundamental bargain or implicit contract is made with the workers. They become more like members of the company in terms of governance, security, and company investment in upgrading their skills, but in return they agree to become more dynamic and cooperative in terms of upgrading their knowledge and skills and adopting new technologies for the company. Becoming more a part of the company gives not just rights but also brings responsibilities to change and adapt along with the company to stay competitive.

In a low road strategy, the employees become much more expendable as the company searches for the lowest cost way to stay in business which usually means exiting jobs or whole factories from the home country to low-labor-cost countries. The end result after many years is that the

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
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<tbody>
<tr>
<td>Cash</td>
<td>ESOP Loan</td>
</tr>
<tr>
<td>Inventory</td>
<td>External Equity:</td>
</tr>
<tr>
<td>Equipment</td>
<td>Ext. Paid-in Capital</td>
</tr>
<tr>
<td>Land</td>
<td>Ext. Retained Earnings</td>
</tr>
<tr>
<td></td>
<td>Internal Equity: (ESOP)</td>
</tr>
<tr>
<td></td>
<td>Individual Accounts</td>
</tr>
<tr>
<td></td>
<td>Suspense Account</td>
</tr>
<tr>
<td></td>
<td>minus Loan Balance account</td>
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</tbody>
</table>

Company Balance Sheet

<table>
<thead>
<tr>
<th>Assets Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>Inventory</td>
</tr>
<tr>
<td>Equipment</td>
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<td>Land</td>
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corporate headquarters and perhaps design or research facilities will remain in the home country but the other jobs will go to lower cost environments. Instead of moving up to higher valued-added and knowledge-intensive jobs along the high road, the domestic workers will move to lower skilled service jobs (often several jobs) in their home country. In return, they are assured that the commodities they buy as consumers will be cheaper since they were produced elsewhere at much lower costs and there will be lots of service jobs in selling the cheaper items in their home country.

Japan is the closest country that has followed a high road strategy in the larger firms. Korea cannot simply copy the Japanese experience but it certainly can learn a lot by studying the Japanese companies. And then it can see how Korea might try to build on its own past and reinvent an appropriate commitment-oriented high road strategy for Korea.

In the US literature on ESOPs, the emphasis is on ownership as if the worker is making an investment on the stock market and then there is some incidental attention paid to participation and governance issues in the company itself. I propose to reverse that emphasis so that the topic is fundamentally about making the workers into members of the company with all that this implies for participation and governance, and then using the ESOP experience to make sure that the financial dimension of the membership is also recognized (as was not done in the Japanese example).

**Using ESOP to make Employees into Members**

Building on the American ESOP experience, an ESOP structure could be devised that would, in effect, turn the employees into members of the company. The equity of such a firm is divided into two parts:

1. **the workers’ portion of the equity** which is the “internal equity” and
2. **the external portion of the equity** owned by outside shareholders.

In an American corporation, there is a difference between shares that are *authorized* and shares that have been issued to become *outstanding*. A certain number of shares (assume all common voting shares) are authorized in the original corporate charter. Some of these shares are then issued to shareholders in return for their paid-in capital so those shares are then outstanding. If a company bought back or redeemed any shares, those shares would not be outstanding and would be retired to the company treasury until re-issued. Only the shares that are issued and outstanding can vote or receive dividends. The authorized but unissued or redeemed shares can neither vote, receive dividends, nor reflect any net worth.

In what follows, we assume the ESOP firm is organized as a corporation with common voting shares. In an ESOP corporation with shares, the inside ownership is *a category of issued and outstanding shares*; it is not unissued or treasury stock. The shares could be held externally in a separate association or trust. But it is more in the spirit of making the workers into members of the company to use the internal ESOP structure described above. It is all part of the company. The workers’ stock is issued and outstanding but held in the firm in an internal trust for the employees.
There are also different ways to organize the workers' shares according to what is recorded in each worker's individual capital account. In the more conventional setup, there are so many shares recorded in the capital account. But it is also possible to directly record a certain amount of capital value in the account. The choice is between share-based accounts or value-based accounts. An ESOP company is considered more "democratic" if the employees vote on a one-person-one-vote basis. Then all the worker shares are voted according to the majority of the worker votes or proportionally as the workers vote. All those are various design options. Since the share-based ESOP accounts are the well-known conventional ones, I will focus here on the more democratic option of value-based accounts and one-person-one-vote.

Each worker does not own a certain number of shares since the workers’ portion of the company is to be organized in a labor-based democratic fashion. The worker shares are held collectively in trust for the workers and are unmarketable. The workers vote on an agreed-upon basis as to how the collectivity or the proportions of the worker shares will be voted. The workers would elect a number of representatives to the board of directors proportional to the workers’ portion of the equity (e.g. one third of the directors for one third of the equity). The worker representatives on the board would form a natural subcommittee to control the shares in the workers’ portion of the equity in analogy with an ESOP governing committee in the American external ESOP.

Some shares have a par or face value that is the value for which the shares were originally issued, but that value has no significance later on. Often shares are no-par shares with no par or face value; they simply have some original issued value. After a company has been in operation, the shares will have a book value (net book value divided by the number of common shares). If the shares are marketable, they will also have a market value. The book and market values are in general different from the face or issued values of the shares. The relevant valuation of the worker shares in a democratic firm is their net asset value or “economic book value”. The balance sheet is as follows (the same as Figure 7 above except that we now consider the ESOP accounts to be value-based).

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
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</thead>
<tbody>
<tr>
<td>Cash</td>
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<td>Ext. Paid-in Capital</td>
</tr>
<tr>
<td>minus Accum. Depr.</td>
<td>Ext. Retained Earnings</td>
</tr>
<tr>
<td>Real Estate</td>
<td>Internal ESOP:</td>
</tr>
<tr>
<td></td>
<td>Individual Capital Accounts</td>
</tr>
<tr>
<td></td>
<td>Suspense Account</td>
</tr>
<tr>
<td></td>
<td>minus Loan Balance Account</td>
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</table>

**Figure 8: Democratic ESOP Firm's Balance Sheet**

The total book value of the worker shares is divided between several types of internal capital accounts in the internal ESOP:

(1) each worker has a value-denominated *individual capital account* which would contain a certain amount of value (not a certain number of shares);
(2) there is a *suspense account* which serves as a temporary collective account or “holding pen” for value to be eventually allocated to individual accounts; and
(3) there would also be a (debit-balance) *loan balance account* which could be treated as a contra-equity account.

A company typically runs several accounts such as total year-to-date compensation or accrued vacation time. A worker’s individual capital account would be another account maintained for each person in the company.

Each worker could have a membership certificate, but it would be quite different from a share certificate. The number of shares in the total workers’ portion might grow over time, but each worker only needs one membership certificate to signify membership. Each year, the workers would receive Capital Account Statements showing the transactions in their accounts due to the year’s operations and the resulting ending balances.

Some details can be best illustrated by considering a concrete example. Consider a democratic ESOP firm where one-third of the ownership is inside or workers’ ownership. There could be, say, 960 shares issued and outstanding with 33 per cent or 320 shares held in the firm as worker shares. In a corporate election of (say) board members, there are 960 share-votes, 320 of which are controlled by the workers. The workers vote on a democratic basis as to how their 320 share votes should be cast.

A new worker might pay in a standard membership fee through payroll deductions. Shares with book value equal to the membership fee would be issued by the company to the total workers’ portion of the equity, and that value would be credited to the new worker’s individual capital account.

The workers’ portion of the ownership would be exercised in not only a democratic but a labor-based manner. This means that the workers are residual claimants not because they are external shareholders but because they constitute a certain portion of the membership (e.g., 33% in the example). The capital recorded in their accounts is not the basis for their vote or the share in the profits. It is like a form of internal debt—capital that the members have loaned to the company and will eventually be paid back, perhaps according to the rollover plan. Workers would receive wages and salaries as usual, and then 33 per cent of the profits would be allocated among the workers according to their labor—after interest is paid on the capital accounts.

Profits will accrue to the workers in two ways. A firm-wide decision might be made for some of the profits to be paid out in dividends on the shares. Then, in the example, 33 per cent of the dividends would go to the workers collectively to be divided between them according to their labor. The dividends could be paid out in cash, or they could be added to the capital accounts and then used to pay out the oldest account entries according to the rollover plan. The remainder of the profits (not declared as dividends) would be retained so they would increase the net book value per share. The nonmarketable shares in the workers’ portion are valued for accounting purposes at book value. Hence 33 per cent of the retained profit (= increase in net book value) would accrue to the workers’ individual accounts.
The allocation formula between worker accounts depends on whether the individual capital accounts bear interest or not. Accounting is simpler if interest is ignored, but interest is the only compensation proportional to the larger risk borne by large account holders (older workers). The interest comes out of the workers’ retained profit. The interest should be added to each account with the remainder of the workers’ retained profit (their one-third)—which could now be negative—allocated between the accounts according to labor. If there are little or no profits, the interest is still added to the workers’ accounts and the correspondingly more negative retained profits (i.e. greater losses) are allocated between the accounts according to labor.

It should be remembered that the workers do not have any individual ownership of shares; only the capital value is represented in their individual capital accounts. In the democratic ESOP firm, the shares still package together the three main rights in the ownership bundle (voting, profit, and net asset rights). But the workers’ portion of the ownership is organized in a labor-based democratic manner so the voting and profit rights (carried by the shares in the workers’ portion) are split off and assigned as personal labor-based rights to the workers’ role, while the book value of the worker shares is allocated between the capital accounts (individual and suspense accounts).

A worker’s account would be paid out in the regular rollover payouts (assuming the rollover plan is used) with the remainder paid out after termination or retirement. There are several ways to consider the payouts on the capital accounts when the firm is not 100 per cent worker-owned. If a cash payout, in accordance with the rollover plan or upon termination, is from general funds of the company (and there is no proportional payout to the external shareholders), then worker shares with book value equal to the payout should be retired to the company treasury.

Alternatively, if there was a cash dividend on all shares, then the worker portion of the dividend could be credited to the accounts according to current labor and then used to rollover the oldest account entries or to pay out terminated accounts. In that case, there would be no need to retire an equal amount of shares since the external shareholders received their proportional part of the dividend payout.

**The Capital Account Rollover Plan**

When should the accounts be paid out? One idea is to leave the account until the worker retires or otherwise terminates work in the enterprise, and then to pay out the account over a period of years. There are several reasons why that termination payout scheme is not a good idea.

By waiting until termination or retirement for the account payout, the accounts of the older workers would be much larger than those of the younger workers and thus the older workers would be bearing a grossly unequal portion of the risk. Risk-bearing should be more equally shared between the older and younger workers. Moreover, it would create an incentive for the older and better trained workers to quit in order to cash out their account and reduce their risks. For young workers, retirement is too distant a time horizon. Current profits would be an almost meaningless incentive for them if the profits could not be recovered until retirement. And finally cash flow planning would be difficult if the cash demands of account payouts were a function of unpredictable terminations.
These problems with the termination payout scheme are alleviated by a “capital account rollover scheme” wherein the account entries are paid out after a fixed time period. The allocations to the accounts are dated. Cash payouts should be used to reduce the older entries in the capital accounts. If an account entry has survived the risk of being debited to cover losses for, say, seven years, then the entry should be paid out. That is sometimes called a “rollover” (as in rolling over or turning over an inventory on a first-in-first-out or FIFO basis) and it tends to equalize the balances in the capital accounts and thus equalize the risks borne by the different members.

![Diagram of Individual Capital Account Rollover](image)

**Figure 9: Individual Capital Account Rollover**

Current retained profit adds to all members’ accounts (equal additions assumed in the above illustration), and then the cash payouts reduce the balance in the larger and older accounts—thereby tending to equalize all the accounts. The incentive to terminate is relieved since the account entries are paid out after the fixed time period whether the member terminates or not.

Instead of receiving wages and current profit dividends, workers would receive wages and the seven-year-lagged rollover payments. New workers would not receive the rollover payments during their first seven years. They would be, as it were, paying off the “mortgage” held by the older workers—without being senior enough to start receiving the “mortgage payments” themselves.

**The ESOP Transactions with an Internal ESOP**

*The Unleveraged ESOP Transaction*

There are a number of ways in which company shares become worker shares. For instance, the basic idea is that a worker should qualify as a member of the company by working there on a long-term basis. This would apply to all people who work on a long-term basis in the firm regardless of whether they are management or shop floor workers, white or blue collar workers. In other words, the ESOP should be broad-based and non-discriminatory. There might be a certain probationary period (e.g., 6 months or a year). And there might even be a membership fee (e.g., one month's salary) for purely psychological reasons as a commitment mechanism.
This fee could be paid by payroll deduction over a period of time. Legally the membership fee would add so many shares issued at their current book value to the already existing total of workers' shares. The capital value of the membership fee would be credited to the member's individual capital account.

To be consistent with the non-marketability of the worker shares, all share transactions between the company and the worker shares are at their current book value. There is no speculative element (discounted future profits to be earned by future workers) in the current workers' capital accounts. To increase the value in the worker accounts, the net asset value (book value of the equity) of the company itself needs to increase (so there is no incentive for market price manipulations that have plagued share option schemes).

But shares could also become workers' shares through some profit sharing by the company in the form of shares, i.e., the unleveraged ESOP transaction. In this profit-sharing (as in all profit-sharing), the quid pro quo is indirect rather than direct. There may have been concessions in labor bargaining which will benefit the company in the future or the profit sharing might be a contribution to increasing worker productivity and identification. On the balance sheet, the immediate effect of issuing, say, 20 shares to the workers is some dilution of the existing shareholders by the newly issued shares. The 20 new shares are added to the workers' shares and the book value of the shares is distributed between the worker accounts in accordance with their current labor compensation.

**The Leveraged ESOP Transaction**

Consider a democratic ESOP firm that starts off entirely or almost entirely externally owned. Then a loan is channeled through the workers' portion of the equity as an “internal ESOP” in order to increase the workers’ share of the company.

There are (say) 660 shares, 640 held by the external owners, 20 held by the workers, and the share book value was $1,000 each. Let us suppose $300,000 is borrowed by the firm from a bank. With the loan channeled through the workers’ portion of the equity, 300 (= 300,000/1,000) new shares are issued to the workers’ portion of the ownership so the workers then have 320/960 or 33 per cent of the ownership. However, the share value is allocated to the suspense account and is balanced by the same value in the Loan Balance contra-equity account.

Each loan payment is divided into a principal and interest portion. In many countries such as the United States, the interest portion is already an expense deductible from taxable corporate income. The principal portion is to be treated as a labor expense so that it would also be deductible as an expense from taxable corporate income. This procedure would need to be approved by the relevant tax authorities—as it has been approved in the United States.

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13However the total of the individual capital accounts and the suspense account minus the loan balance account will not in general equal the number of worker shares times the net book value per share.

14 Conventional accounting practices do not pick up changes in the market value of fixed assets except when the assets are sold and then there would be an capital-gains or losses element in the net income. In some systems of worker ownership (e.g., the Mondragon cooperatives), the asset side of the balance is periodically reappraised so that those capital gains or losses are imputed to the capital accounts independent of the time of realization.
A value amount equal to the principal payment is allocated from the suspense account to the individual accounts to be divided between them in accordance with labor. It is as if each principal payment is paid out to the workers as a bonus and then immediately reinvested in worker equity, and the money is then paid to the bank as the principal payment. In this manner, the ESOP firm with an internal ESOP mimics the leveraged ESOP transaction.\textsuperscript{15}

It should be remembered that changes in the worker accounts resulting from retained profits or losses are always taking place at the end of the fiscal year in addition to the credits relating to the principal payments on ESOP loans. Those year-end profits or losses of the firm are computed with the principal payments treated as a labor expense.

When the loan is paid off, the principal amount of the loan will have been allocated between the individual accounts. The financial reward to the whole company for channeling the loan through the “internal ESOP,” the workers’ portion of ownership, is that the principal payments on the loan were deducted from taxable income. The increased worker ownership should also reap other rewards through the greater motivation and productivity of the workers and greater psychological identification with the firm in accordance with the legal role of membership.

\textit{The Leveraged ESOP Buyout Transaction}

In the previously described leveraged internal ESOP transactions, the loan money went to the company, and the worker shares were newly issued and valued at book value. An alternative leveraged transaction is to use the loan proceeds to buy externally held shares for the workers’ portion of the ownership.

The bank or financial institution loans money to the company. The cash is passed through the company and used to buy back externally held shares from the external party holding the shares. However, instead of interpreting this as a share redemption (which would retire the shares to the corporate treasury), it is viewed as the workers collectively buying the shares from the external owners. Hence those shares enter the workers’ portion of the ownership (suspense account) instead of the corporate treasury, and the workers would determine how those share votes are to be cast.

On the balance sheet, those shares switch from external to internal ownership. The ESOP loan is a liability of the company and it is balanced in the Loan Balance account. The ESOP loan is then paid off as usual with deductible principal payments and with the value of the principal payments "seeping" from the Suspense account into the Individual Capital accounts.

\textit{Implementation Questions}

How can the democratic ESOP firm be implemented? There are questions involving both corporate structure and tax benefits. The corporate structure of the democratic ESOP firm should at best be implemented by additions to existing corporate statutes authorizing the creation

\textsuperscript{15} In accounting terms, a (say) $500 principal payment would be credited to Cash and debited to Labor Expense. Then $500 is debited to the ESOP Loan account to signify the reduction in amount owed and $500 is credited to the debit-balance contra-equity Loan Balance account. And finally $500 is debited to the Suspense account and is credited to the Individual Capital Accounts in proportion to some measure of labor compensation, e.g., each member’s year-to-date (YTD) compensation in proportion to the members’ total YTD compensation.
of the "workers’ portion" of the equity of a company. Legislation should be preceded by experimentation. The structure could be experimentally implemented (without legislation) in an enterprise by appropriately drafting the charter and by-laws of the enterprise and obtaining the agreement of the present owners and the Workers’ Assembly. These could be developed as simple amendments to existing charters and by-laws to add the workers’ portion of equity onto an existing joint stock company. After the development of a model seasoned by experience in a particular country, appropriate legislation can be drafted and passed.

The tax benefits of the internal ESOP or external ESOP transactions would require authorization from the tax authorities. This requires both allowing the principal payments on loans channeled through the workers’ portion of equity to be deducted as labor expenses and deferring any personal income tax incidence for the workers until the capital accounts are paid out.

There are reasonable arguments for both tax benefits as well as the strong American precedent. It is as if the principal payment was paid out as a deductible labor bonus and then immediately rolled over into equity shares in the company (the equity injection then being used to pay off the loan). Or one could think of the company as making the principal payment directly to the bank and simultaneously issuing an equal (book value) amount of shares to the workers’ portion of the equity as a deductible profit-sharing bonus in stock. In either case, it should be a deductible labor expense to the firm. The workers have no increase in their disposable income so it is reasonable to defer personal taxation until the capital accounts are paid out.

American ESOPs use trust law. Trust law tends to be quite different, idiosyncratic, or non-existent in other countries. Rather than have the costly and bulky apparatus of the external ESOP trust as in current American law, the internal or workers’ portion of the equity could be a normal part of every company. Alternatively or in addition, a country could draft laws to create the machinery of trusts and then the machinery for the external ESOP trust.

Concluding Remarks for Part II
There are a number of ways that the Korean experience to date with ESOPs could evolve. I have suggested one path but many others are possible. The important thing is to encourage experimentation to see what works and what doesn’t.

The path I have suggested is a commitment-oriented high road strategy to face the challenges of globalization. It involves using ESOP-like structures to turn the employees into members of the company along side the conventional external shareholders. There are many design options but I outlined one that consistently treated their membership as being labor-based. That is, the firm is treated less as a piece of property with "owners" and more as a human community of work where people are members because they work there. It is a hybrid form. According to the basic division of the shares into external and internal equity, the external shares will operate in a conventional manner and the internal equity will be organized in a labor-based democratic (one-person-one-vote) manner. In that version, the employee-members are not like external shareholders who accidentally work in the firm. They are members because they work there. This idea is present in the American ESOP (but is not emphasized) since the shares taken out of the suspense account are reallocated to the worker accounts according to labor compensation. Thus it is a labor-based allocation. In the democratic ESOP structure, I carried out that labor-based idea in a more
thorough form. The end result may be something like a legally implemented version of the informal structure that has evolved in the large Japanese companies.

Each company that wants to use an ESOP structure should be able to design within certain parameters a structure that suits its "concept" of the employees' role and there should be some flexibility to change as experience accumulates. For this type of experimentation, Korea needs legislation to enable companies to move beyond the original Korean ESOP to explore new options.
References


