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EMPLOYEE STOCK OWNERSHIP PLAN

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ABSTRACT

EMPLOYEE STOCK OWNERSHIP PLAN

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This plan was built up by Louis Kelso in 1956 in order to help employees to own the stocks and shares of the company. More application areas were consisted in parallel to the demand of the companies such as rescuing in bankruptcy situations, stopping green mail attempts of the competitor companies, consisting profitable and efficient companies and composing additional retirement security plans for the employees. This system is basically built on the philosophy of ‘The more you pay, the more you get during retirement’. U.S. government accepted the system and made it stronger with the help of the tax reforms and legislation. In this paper, the history of the plan, its legislation and application areas were analyzed. Adding to these, the performances of the companies in recession, the benefits of the system to the economy and the challenges that a mature company could face have analyzed. Finally, with the help of the SWOT analysis, all strengths and weaknesses were emphasized, potential opportunities and threats were researched and possible solutions were suggested.

Keywords: Employee Stock Ownership Plan, Louis Kelso

ÖZET

ÇALIŞANIN STOK SAHİPLENME PLANI

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Ekonomi, Yüksek Lisans

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1956 yılında Louis Kelso tarafından çalışanların içinde buldukları kuruluşların hissedarı olmalarını sağlamak için oluşturulmuş bu sistem daha sonraları şirketlerin iflastan kurtarılması, rakip firmalar tarafından satın alma yoluyla sindirilmelerinin engellenmesi, karlı ve verimli şirketlerin oluşturulması, çalışanlara devlet tarafından sunulan sosyal haklar dışında ek emeklilik hakları sunulmasına kadar birçok farklı şekilde kullanılmıştır. Temel olarak çalışanın sisteme yatırdığı paranın karşılığını prim ya da emeklilik sırasında yine sisteme satacağı stoklar şeklinde alabildiği bu sistem yıllar içerisinde Amerika Birleşik Devletleri'nde Kabul görmüş, devlet tarafından desteklenmiş ve çıkan yasalarla çalışanların hakları devlet koruması altına alınmıştır. Bu çalışmada planın tarihçesi, oluşumu, yasalaşması, uygulama alanları, ekonomik durgunluk ve gerileme gibi zorlu durumlardaki performansı, ekonomiye olan getirileri ve uzun vadede bu planı başarıyla uygulayan firmaların karşılaşacağı sorunlar ve bunların muhtemel çözümleri detaylı olarak incelenmiştir. SWOT analizi yardımıyla güçlü ve güçsüz yanları, oluşabilecek fırsatları ve tehditleri değerlendirilmiş, potansiyel çözüm önerileri sunulmuştur.

Anahtar Kelimeler: Çalışan stok sahiplenme, Louis Kelso

INDEX

LIST OF THE TABLES AND CHARTS

1. INTRODUCTION	1-3
1.1. SUBJECT AND THE PURPOSE OF THE RESEARCH	1
1.2. IMPORTANCE OF THE SUBJECT	2
1.3. METHODOLOGY	3
2. EMPLOYEE STOCK OWNERSHIP PLAN	5-37
2.1. GENERATION OF THE E.S.O.P.	5-9
2.1.1. An Optimal Mixture of Capitalism and Marxism	5
2.1.2. Structural Defects of Capitalism	7
2.2. HISTORY OF THE E.S.O.P. AND APPLICATION EXAMPLES	9-20
2.2.1. Constitution by Louis Kelso	9
2.2.2. Legislation of the Employee Stock Ownership Plan	11
2.2.3. Employee Stock Ownership Plan as Stock Exchange	12
2.2.4. Tax Reforms for Employee Stock Ownership Plan	13
2.2.5. Application Types of Employee Stock Ownership Plan	15
2.2.6. The Status Changes in Employee Stock Ownership Plans due to Main Economic Megatrends	17
2.3. ANALYSIS ON THE BENEFITS OF THE EMPLOYEE STOCK OWNERSHIP PLAN TO THE U.S. ECONOMY	20
2.4. THE PERFORMANCES OF THE EMPLOYEE STOCK OWNERSHIP PLAN COMPANIES IN THE RECESSION	27
2.5. THE CHALLENGES OF THE EMPLOYEE STOCK OWNERSHIP PLAN COMPANIES IN THE LONG RUN	33
3. SWOT ANALYSIS	37
4. CONCLUSION	41
5. REFERENCES	43

LIST OF THE TABLES AND CHARTS

Chart1. ESCA Member Employment vs. Total U.S. Employment	24
Chart2. ESCA Employment vs. S ESOP Active Participation Levels	25
Chart3. Total Number of S ESOP Companies	26
Chart4. Total S ESOP Participants	26
Chart5. Active Contributors of S ESOPs vs. U.S. Employment	27
Table1. Related Data of 2008 for S ESOP Companies	31
Table2. Related Data of 2008 S Type Companies vs. U.S. Economy	32

1. INTRODUCTION

1.1.SUBJECT AND THE PURPOSE OF THE RESEARCH

‘The real tragedy of the poor is the poverty of their aspirations’ said Adam Smith. (1) Many economists argued on the fact that whether the main problem of the poor people is not having enough faith and aspiration in success or not having available opportunities to be successful as an entrepreneur. Existing governments and political systems are not adequate enough to solve the problem of poor and rich. Marx stood for the fact that each gain in the economy must be distributed fairly between each citizen. (2) Both capitalism and Marxism have some defects internally and the optimized mixture of both theories can be called as ‘People’s Capitalism’. In order to end up with best proposal, taking the equivalence part of the Marxism and curing the main defects of capitalism will be the appropriate way. In this paper, the main purpose is trying to open a way, for people who are not rich, in order to own their job in an alternative way, via becoming shareholder of the company in which they are working for. In 1956, Louis Kelso created an elegant way for this issue and this system is basically called as ‘Employee Stock Ownership Plan’. (3) It was the optimal solution for the companies which are near bankruptcy, benefiting both employee and the owner of the company. In this paper, Employee Stock Ownership Plan’s history, its strengths, weaknesses, opportunity areas and threats are analyzed in detail. Alternative application and execution areas are searched and finally overall evaluation and discussions are done at the end of the paper.

1. Adam Smith Institute <http://www.adamsmith.org/quotes>
2. Adam Smith Institute <http://www.adamsmith.org/quotes>
3. Australian National University <http://www.anu.edu.au/polsci/marx/>

1.2.IMPORTANCE OF THE SUBJECT

Employee Stock Ownership Plan can solve many problems in the system if it is used effectively and efficiently. First of all, all the employees in the system have the right to say a word in important subjects such as pricing, side benefits of the workers, earnings and salary, production planning and management. This system also balances delegacy and responsibilities in the Employee Stock Ownership Plan. In terms of efficiency, this system clearly improves the efficiency of the company since every employee feels himself as the shareholder of the company and also loyalty of the employee improves with this system. Improvement in efficiency directly increases the production and this increase in the production increases the salaries and earnings of the employees.

Companies pay on the retirement plans and financing funds. Government guarantees tax reduction for these payments with laws. This tax reduction system helps companies to get more cash money and companies can easily avoid taking credits from banks with high interest rates.

Employee Stock Ownership Plan basically built on the philosophy of ‘The more you pay to retirement plan, the more you get when you retire’. (4) Since this is guaranteed by law, each employee is willing to pay more to the finance of the company. This also helps the company to have a healthy financing system.

In bankruptcy situations, the government has to take the lead and rescue the company. This procedure is a hump on the shoulders of the government.

4. The Kelso Institute <http://kelsoinstitute.org/>

With the help of this system, any company can rescue itself via effectuating Employee Stock Ownership Plan. Finally, in the long run, this system will be widely used and inflation will decrease with this mechanism.

Overall, when the business is going well, any system can solve daily problems. But in extra ordinary situations, an alternative for current systems is needed. Employee Stock Ownership Plan can solve many defects of the current systems and in the long run, it also helps government in bankruptcy situations and by decreasing the inflation.

1.3.METHODOLOGY

Employee Stock Ownership Plan built on the philosophies driven by People's Capitalism. In order to analyze the subject in a methodological manner, defects of capitalism are analyzed and with the help of the solution suggestions, Employee Stock Ownership Plan has appeared as the best alternative for the defects. Secondly, detailed history is given about Employee Stock Ownership Plan and many application types around the world in different industries are given. These examples show cases in which many bankruptcies were rescued with this mechanism. Following this, the benefits of the system to the U.S. Economy is analyzed. This basically creates links between employee commitment, firm performances, productivity and efficiency. But what about the extra ordinary situations like recession? In this paper, the performances of the Employee Stock Ownership Plan Companies in the recession are also analyzed. It is also shown that ESOP companies stayed at least flat while other companies had a dramatic decrease in terms of

production and sales. Finally, the challenges of the mature ESOP Company in the long run are analyzed in detail.

2. EMPLOYEE STOCK OWNERSHIP PLAN

2.1.GENERATION OF THE E.S.O.P.

2.1.1 An optimal mixture of Capitalism and Marxism

‘The real tragedy of the poor is the poverty of their aspirations’ said Adam Smith. (5) Many economists argued on the fact that whether the main problem of the poor people is not having enough faith and aspiration in success or not having available opportunities to be successful as an entrepreneur. The discussion basically starts in the heart of the capitalistic manner of open market economy, U.S. The capitalism has been applied in the economy perfectly and as a result of this, production and productivity increased, average income of the citizens of the country has increased rapidly in past years but as every system has, capitalism also has some defects. Marx stood for the fact that each gain in the economy must be distributed fairly between each citizen. (6) Both capitalism and Marxism have some defects internally and the optimized mixture of both theories can be called as ‘People’s Capitalism’. In order to end up with best proposal, taking the equivalence part of the Marxism and curing the main defects of capitalism will be the appropriate way.

The main defects of the capitalism can be classified in three headings. Firstly, if you are not rich, it is not possible for you to take credit from the banks. Secondly, the primary source of the income is wages and salaries. Finally, money withholding is the main counterproductive mechanism for fighting inflation. (7)

5. Adam Smith Institute <http://www.adamsmith.org/quotes>
6. Australian National University <http://www.anu.edu.au/polsci/marx/>
7. Columbia University <http://capitalism.columbia.edu/theory-capitalism>

People's Capitalism and the systems driven by this trend give opportunity for investment to the people also who are not rich. Wages and salaries, in addition, are fed by the earnings followed by the investments. In order to control inflation, above mechanism also works well and with the help of this system, each gain can be distributed between citizens fairly.

In capitalistic manner, current economies are adequate enough to produce enough goods and services. If needed, more can be produced via increasing capacity of current production firms and services. World's production capacity is not used effectively and half of the world is still demanding the primary education, does not own a safe place to live and still not having basic nutrition. Despite few weak attempts, there are no serious policies set to achieve this target and many people doubted if the current policies and production lines are adequate enough to meet the criteria in a profitable manner. In many aspects, capitalistic economic system proved its ability to produce services and goods far more efficiently than any other economic systems. But the defect is 'not sharing the benefits fairly'. The half population of the world is earning \$2 per day and they are even not able buy their basic needs. At the counter side, few people are earning \$100000 per day in rest of the world. ⁽⁸⁾ It can be seen that current policies are not even closer to build up a world with fair distribution in terms of wealth.

The reason for capitalism not to produce more is not lacking productive capacity. Each and every shopping mall is filled with many goods which are fiercely competing with each other to take share in the market.

8. World poverty statistics <http://www.globalissues.org/TradeRelated/Facts.asp>

The reason for not producing more is lack of the demand in the market. In other words, the most common failure reason for a business is selling the goods with little profit. But, on the other side of the coin, the world is desperately demanding food, shelter, clothing and health care. Half of the world is potential customers for goods and all they need is an income. If any solution can be found for poor people to earn money, goods can be sold with a profit, more people will be able to find a job and the quality and life standards of the half of the world will be improved.

2.1.2 Structural Defects of Capitalism

The structural defects of capitalism must be analyzed in detail and possible solutions must be found. Firstly, the main income channel is wages and salaries for most of the people. They sell their labor or intellectual skills. In today's world, productivity improvements are making production of more goods possible with less labor. Adding to this, each and every day, new population of young people is entering market as a qualified labor. As a result of these facts, a major problem appears. Unemployment rise both in developed countries and poor countries. Salary rates are declining because of the advanced technology and the need of the work force is declining day by day. Decline in the need of the labor also decreases the power of the employee in terms of bargaining. In the modern post-industrial economies, wealth of the employee has been declining because of the decrease in the salaries and in the poor countries; there appears no exit way from poverty for poor people.

The second structural defect of the current capitalistic manner is if you are not rich enough, there is limited access for the credit for investment. Many banks are willing to give credit for consumption or for the daily needs but not for investment for a new entrepreneurship. As a result, it is almost impossible for a poor investor to take credit from a bank for investment.

The third defect for the current world is that the monetary policy is not effective enough to control inflation. Policies are trying to reduce investments in order to control inflation but the primary source of the current economies is the investments done by new investors. If interest rates raise, investment, economic growth and productivity decreases. Also, if there is a time delay in the prices seen by customers and the rates of the interests, it may lead a recession in the economy. In order to avoid large fluctuation in the market, the economy must response fast? If the economy cannot response fast or if the economic growth is bigger than 3%, there happens instability in the market. (9)

Adding to this, if monetary restraint is not applied, instability also occurs in this situation. It has been shown in many economies that growth rates bigger than 6% in the economy can be sustained only for few years if government cannot take precautions. (10) This is also valid for U.S. that it is only possible to sustain 6% economic growth by Federal Reserve Actions.

9. World population statistics <https://www.cia.gov/cia/publications/factbook/print/xx.html>

10. Treval C. Powers, Leakage: The Bleeding of the American Economy (1996)

There were many actions built in order to solve these structural defects of capitalism. Encouraging people to invest on productive enterprises and establishing mutual funds in order to supply credits to non-rich people for investment were basic precautions. Adding to these, in order to fight the inflation, mandatory withholding of savings was done. These actions were not realized effectively. Half of the world population is still living with \$2 per day. Yet, the lucky investors who succeeded in taking credits and investing in enterprises faced with the same problem. After taking the credit from the bank and investing this credit to productive enterprises, they faced difficulties in surviving. Many theories were discussed and many solutions were proposed but in the world of reality, one solution plan which was created in 1956 by Louis Kelso was gained acceptance called 'Employee Stock Ownership Plan' widely by many companies.

2.2.HISTORY OF THE EMPLOYEE STOCK OWNERSHIP PLAN AND APPLICATION EXAMPLES

2.2.1 Constitution by Louis Kelso

Louis Kelso generated the world's first ESOP in 1956 to build up the most efficient way of transferring shares to the employees. He believes that, the most logical buyers and ultimate owners must be company's employees who play the major role in successful business and who know all the handicaps of the business. Owners of the company gave employees open check and engage a word on retirement, if it is requested by employees, they will retire. They also experienced that if acquisition with another company is chosen as a solution instead of ESOP by

other companies, all key employees were being laid off and the board of the company was being remixed to decrease costs.

At this point, one major question arises, 'How can employees find enough money to buy the company and the business?' If employees cut their costs hardly, borrow all the money that they can and mortgage their homes, only the interest part can be paid and the main debt is impossible to be paid.

IRS tax-qualified profit-sharing plan was chosen by Peninsula Newspapers and the accumulated funds were sufficient enough to decrease payment by 30%. But, if this value was chosen to be used, the employees would face with the risk of losing a major part of their retirement funds. After cogitation on losing their job in the case of acquisition, all employees end up with using this plan. Still, one gap remained to cover the company's cash flow and at this point, Kelso came up with a perfect idea. If profit sharing plan itself borrows the money, instead of taking it from the bank and paying principal with after-tax dollars, it will repay principal and interest with pretax dollars. Of course Kelso did not originate employee ownership. Moreover, the effects of this plan on increasing employee incentives and productivity cannot be measured. Before the attempts of Kelso, many companies like Procter & Gamble, J.C. Penney, and Pillsbury relied on employee ownership to increase motivation and productivity.

The plan on tax qualification of Internal Revenue Service which is basically designed to be invested on the company shares is used as a tool for succession. This plan includes all the needed parts covering the employee benefits and hold of the stock for the long term benefits. Before the implementation of the plan, owner of the company can either sell the company to the third party or become willing to give a part of the company to the chosen employees. In the case of Peninsula Newspapers,

owners realized that selling the shares to a competitor will help them to gain cash but the acquisition will directly affects owned company by buyer's company and lost its identity. Adding to this, selling out stock can be an alternative escape for the company but since these stocks cannot be paid with pretax dollars, it will take years to enclose the payment problem. Finally, unfortunately public offering cannot be an alternative way for small companies.

2.2.2 Legislation of the Employee Stock Ownership Plan

In legislation side, it took 18 years for ESOP to be fully accepted. Internal Revenue Service controlled all attempts of this plan for 8 years. In 1964, IRS ruled that, instead of having controls via National Office, all trust document reviews would be done by IRS regional offices. (11) After the transition to regional offices, this plan became effortless and simple in terms of designation and finally this plan was added to Employee Retirement Security Act in 1974 by Senate. (11) The Senate was not aware of the details of the employee stock ownership plan and any deal with this plan and bankruptcy owner was forbidden. Fortunately, ESOP was brought to the attention of the Committee and ESOP got exception. Ended version of the plan was added to Employee Retirement Security Act within six months.

Within 10 years period, Internal Revenue Service did not manage to define parameters of the plan and in 1974 unemployment rate was 10%. (11)

11. Freeman, Steve, and Michael Knoll, University of Pennsylvania Center for Organizational Dynamics, Working Paper #08-07, 2008.

All banks stop lending and all companies tried to survive with their debts. Moreover, personal income rates were smaller than all tax rates. Business owners stopped investing on their businesses so economy became static and fossilized, encouraging preservation. Following these, the plan became the unique exit way for the owners of the companies.

2.2.3 Use of Employee Stock Ownership Plan as Stock Exchange

Following this years, beginning from 1979, a new application of ESOPs came along, using this plan to survive failing companies. All the companies which were willing to use this plan as stock exchange offered employees a unique trade of. They promised stock in exchange but the opportunity cost for this was wage reduction. The most known companies using this solution were: The Chrysler Corporation, Weirton Steel and United Airlines.

The Chrysler Corporation faced with difficulties in surviving and asked for \$1,5 billion subvention. If it was given by government, the only pay back mechanism was salary reduction of employees. As a trade of, company gave 25% ownership to employees through an ESOP. In the following years, the company was successful in repayment. (12)

National Steel Corporation was decided to shut down the plant in order to minimize the losses and postponed all the investments to the plant. Employees were like minded and decided to agree on salary reduction of 20%. Following this, Weirton plant of National Steel Corporation rescued itself and became more profitable plant than it started. (12)

The United Airlines Company decided to build up an ESOP with the help of the substantial wage reductions. Many of the employees were agreed on decrease in salary and this sacrifice of the employees ended up with \$5 billion capital which enabled to buy ownership of 55% of the United Airlines. In the following years, the agreement on salary reduction ended up and this contribution loss affected the company. Finally, the effects of September 11 forced the company to declare bankruptcy. ESOP saved the company when it was applied but the economic crisis was a complete misfortune for the United Airlines. (12)

2.2.4 Tax Reforms for Employee Stock Ownership Plan

In 1984, reform on tax policies was crafted by Long, the chairman of the Senate Finance Committee, about the plan. Long was conscious of the fact that, in order to encourage business owners to build up this plan, more privileges must be given.

First reform is about tax reduced reinvestment. If the reinvestment was done within 12 months of the sale of the plan, the taxations were also postponed in order to help the trading.

12. Frisch, Robert A., *ESOP: The Ultimate Instrument in Succession Planning*, (John Wiley & Sons, 2002)

In this case, only prerequisite is ESOP's possession of C type ownership at minimum 30%. (C Corporation is kind of a plan corporation which is analyzed independently from its owners in terms of taxation) That is to say, if the seller is suitable seller in terms of law, all illiquid diminishing returns can be turned into liquid without tax in terms of capital gains. This way secured the way of transferring ownership to next generations.

Second reform is exclusion of interests. Lender in the transfer situation has independent income and this lender is responsible for the tax of the income. If it is an qualifying plan, exclusion of 50% of the interest income is available for the lender for 5 years period. It helps owners of the company to pass their investments and companies to the next successful generations.

Third reform is about using freehold properties in the plan as a stock. In terms of freehold property liability, if it is invested to the plan, it solidifies the liability and any freehold property is suitable for transferring liability.

During the following 10 years period, ESOP installations increased dramatically in U.S. economy with the help of this tax reforms. This was the first time government adopted legislation only for business succession of ESOP companies. In the following years, starting from 1976, ESOP structure used in many different ways: to facilitate divestitures, for private transactions, as a defense for hostile takeovers and as a succession tool for business.

2.2.5 Application Types of Employee Stock Ownership Plan

Cash flow and profit have been the major problem for the companies over the years. Each and every company wants to optimize the product lines and increase the cash flow. In order to realize this, companies have been refining the unwanted divisions inside the company and trying to optimize the product lines. Generally, this refining procedure is handled with bank loans and it hardens the management's job in terms of repayment. Employee stock ownership plan appeared as the most logical alternative in terms of credits in refining procedure. On the contrary, if acquisition happens, purchased company can be sold out with higher price to a strong competitor.

Starting from 1974, the economy started to recover itself. Even the stock market fixed the problems and debugged itself; public held companies were not successful enough to recover themselves like privately held companies. All the business owners realized the trend and one by one each public company started to change its status to privately held type. But one major problem appeared in terms of financial payment. If the company transfers itself to privately held type, it must pay all the debt with after tax dollars and the only solution to repay this amount with pretax dollars was applying the employee stock ownership plan, which was guaranteed by law. One of the very first attempts was done in DENTSPLY International Company. This company was the leader in dental market but due to many mistakes done by the managers; this company was faced with bankruptcy. The company tried to sell itself to many potential customers but they were not succeeded. Finally, the company decided to apply this plan and financial problems were solved with this mechanism.

The company succeeded in repayment and rescued itself, still being one of the successful distributors in its industry.

Hostile takeovers rose in 1970 because of the undervaluation of the public companies. Basically, a competitor company tries to gain bulk part of the shares of the company and threaten the company to sell the shares to external parties or force them to buy back the company shares with an extra ordinarily huge price. To prevent these hostile takeovers, 'poison pills' were invented. This system only becomes available in green mail attempt situations and protects the company. At this point, main question is the intent of the company.

The Hi-Shear Corporation, in 1973, was near bankruptcy and trying to find a way through this crisis. One potential customer suddenly appeared and became the candidate for this transaction. The Hi-Shear Company was not sure whether this is a green mail attempt or not, so they concluded to make up a mechanism to prevent the company. They quickly formed an employee stock ownership plan and owned 30% of the shares of the company. Since the green mail attempter did not manage to hold all the shares, this attempt ended up with frustration. Another case was experienced in 1980 for Hawaii Public Company. Employees formed up an employee stock ownership plan to make defense against hostile takeover and were succeeded. Later, this was challenged on the court but the court ended up in favor of the plan. 30 years passed after the court hearing and the plan still owns the major shares of the company.

Following Hi-Shear Corporation and Hawaii Public Company, Delaware changed the legislation of Delaware Corporations Code and discouraged green mail attempters with the article which stops green mail attempts with a mechanism that no

one can finalize the business without taking minimum 85% votes of the employees. Following this, Polaroid and many other companies decided to apply the plan to their companies and stopped many green mail attempts. Day by day, all green mail attempts decreased and finally disappeared. The plan has done many things in order to protect companies from green mail attempts.

2.2.6 The Status Changes in Employee Stock Ownership Plans due to Main Economic Megatrends

Starting from 1980s till now, ESOP has also used as a Business Succession Tool for companies. Major 3 megatrends were applied in the economy and they helped to recover country's defects in terms of the plan.

First megatrend was activated in 1981 and secured that personal income taxes cannot be bigger than corporate tax rates. It forced all the business owners and plan participants to switch to S Status from C status since C status plans are taxed separately from its business owners. But, in terms of ERISA, tax qualified plans are not allowed to hold stock of the S corporations.

In the late 80's, U.S. economy started to be service based economy rather than being manufacturing based economy. There appeared many young entrepreneurs and many consulting and high-tech engineering firms. During 1980 and 1990 period, the number of plan participants and the number of applied plans remained flat since these entrepreneurs were all just started to build up their businesses. But after a time period, they also started to think about the success of their companies. Especially for service based company, selling the company to a third party cannot be a solution. In

1996, Small Business Job Protection Act was published and the government decided to protect these companies due to fierce competition. Now, the number of S Corporations is much more than C corporations and ESCA has been carrying on the studies on the S Corporations and has already formed a lobby for this.

Since the change in the forms of the industries in the economy, also the trends on how employees maintain their rights have been changing. The local U.S. companies are turning into service based companies day by day and all manufacturing companies have started to be owned by foreign countries. Service based companies are in ESOP structured trend in major and union members are smaller than employee owners in the country. As a result, Union Membership has been losing blood and this will be the case in the following years. Adding to this, employee stock ownership plan has been applied by many companies successfully and the plan is in increasing trend among the service based companies.

In 2009, University of Pennsylvania carried out a survey on employee stock ownership plan and realized that every 1 worker out of 12 workers are participating in the plan and the assets that are hold by the plan is around \$928 billion. Moreover, this plan has been using by the service based companies as tool for succession.

Previously, if the owner of the company wants to retire, he had two options. First, he can sell the company to the competitor; it used to be a disaster for employees. Secondly, he can sell the company to a private equity firm. These are no longer logical options for the owner. Each and every company is fighting with their problems, especially in terms of cash; an acquisition with a competitor is not valid. In the credit side, banks are not willing to give credit for selling company to the third party situations since this money is going to the owner of the company. Previously,

banks are willing to give credit maximum to the 5 times of the EBITDA of the purchased company but this is no longer the case. Any investor can only take credits up to 3 times of the EBITDA.

As emphasized, alternatives have been closing one by one and at the end, employee stock ownership plan will be the best alternative buyer in coming years. The plan has many flexible points and it can be used in favor of both buyer and employees. For example, any seller can sell his stocks and still keep control of the company. If the finance is done via seller note, he does not need to sell the stock and take back the seller note. He can also sell stock to the employee stock ownership plan till he balances his shares. Adding to this, selling the shares to an alternative buyer, especially to a competitor, is not fully blocked. If the seller does not insist on extra ordinarily huge price and if this is not a green mail attempt which is approved positively by the employees, this can also be applied. Selling a stock to the third party may cause losing control but these can be healed up.

Basically, in the case of sale to the third party, all the payment must be done with after-tax dollars but in the employee stock ownership plan, the buyer can pay this with pretax dollars. Also, guaranteed by IRC, in C type of employee stock ownership plan situations, the sale can be done tax-free. Moreover, in S type employee stock ownership plan situations, the shares which are contributable to the plan are excluded from the tax.

Starting from Kelso, ESOP has been used in many different ways as a succession tool for the companies. In the coming years due to lack of alternatives, employee stock ownership plan will become the best alternative option for buyout and acquisition situations.

2.3.ANALYSIS ON THE BENEFITS OF THE EMPLOYEE STOCK OWNERSHIP PLAN TO THE U.S. ECONOMY

Many policymakers interested in tax reform in order to change current economic system, many of them analyzed the structure and they realized that job creation by promoting employee commitment is the best way for productivity, economic growth and job stability. As Louis Kelso emphasized, ESOP is the best applicable way for this structure.

Tax reform became a hot topic with the help of the President Obama's recent framework during elections. All economists and politicians are searching for a system to remove peaks in the economy, low tax rates and reduce the gaps of the budget. In order to achieve this, all expenditures on tax and all policies followed by the country must be analyzed in detail and precautions even on reforming or eliminating them must be done. (13)

13. For a more thorough discussion of the economic opportunities presented by income tax reform, see Brill and Viard (2011)

During the previous recession, the economy stayed almost flat in this period. Many academicians and researchers concluded on the fact that current tax code is not sufficient enough for economic stability and growth. In order to nurture economic growth, many tax expenditures must be realized. Keeping this in mind, ESOP structure must be analyzed in terms of tax policy.

Becker explained the commitment of the employee as the employee's psychological attachment to the company and tried to explain the relation of the worker attachment and companies' productivity. He asked if the success of the company is coming from the commitment of the employee or employee is committed to the company since the company is successful. Daniel Koys, the human resource management scholar, found out that customer satisfaction is only available in a company if the employee is willing to work with joy and commitment basically increases the efficiency also. About the commitment and turnover rate of a firm, the economist Francis Green (2008) said that the values of the company must be understood by each employee and with the help of the feeling of the responsibility, each employee must work hard and laziness must be canceled out. Also, since it is a team work, lazy employees or the ones who are not suiting the needs of the company will be canceled out naturally. Also, Brown (2011) examined that if the employee feels the loyalty and attachment to the company, this employee starts to build a link between the employer and himself. As a result, the company is owned also by the employee in terms of feelings. If any agency is added between the employee and employer, this relationship will be reduced. According to Pierce, Kostova and Dirks (2001), being protective, productive, efficient, self-sacrificing can only be the results of the loyalty of the employee.

Feeling the responsibility of the company makes the employee more nurturing. These positive effects of employee commitment resulted in increased profitability and increased output. As emphasized, the best way of applying employee commitment is Employee Stock Ownership Plan and there are many existing evidences on the benefits of the ESOPs.

National Center for Employee Ownership (NCEO) conducted number of studies and all the researchers are agree on the fact that if there is a feeling of responsibility and ownership, it directly affects the performance of the company beyond debate. Douglas Kruse and Joseph Blasi in 2000 found out that even in recession times, employee stock ownership plan at least gives 2.3-2.4% higher wages and always thinks about employee satisfaction (NCEO 2012b).

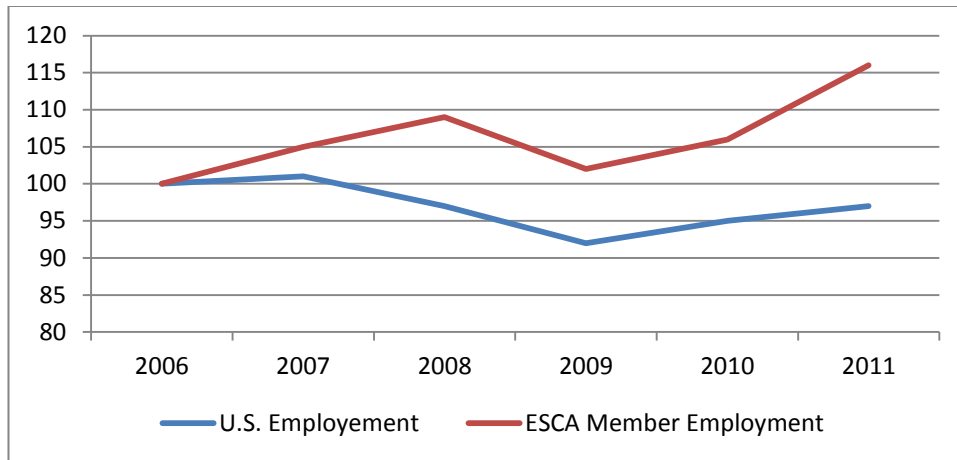
After having 30 researches on the issue, Kruse found out that the increase in productivity is around 5% extra in employee stock ownership plan companies when it is applied and this level of production is valid for following years. In U.S. economy, the productivity growth can reach only to the half of the productivity increase of the companies who are applying the plan. Moreover, this plan supports stability in employment since all the employees are happy to be the part of the organization. Adding to this, Ivanov and Zaima concluded that if any employer wants to increase the equity of the firm and decrease the cost of the capital, the most applicable way is applying the plan to that company, and then the plan will do the rest for the employer.

During the recession in 2008, total employment rate fell by 3% in total U.S. economy where in the companies applying the plan, the employment level grew by 1.9%. This resiliency was valid because of the employee stock ownership plan.

In order to indicate the positive effects of the plan to the economy, many researches were done. Alex Brill (2012) used the data of the last decade and tried to indicate the employment level effects of the plan. The main purposes of the analysis were showing the basic benefits of the plan; the growth occurred because of the plan in the U.S. economy employment rates. He had examined the trends in terms of employment in S type corporations and also comparisons of the total United States data and S type corporations were added to the research.

He basically focused on 56 organizations and focused on 120 members of the organization. 18% of the focus group was in wholesale and retail industry, 29% of the focus group is in manufacturing industry, 23% of the focus group is on technical, scientific materials industry, and rest of the focus group from other industries. As shown in the Chart 1, the growths of S type corporations were bigger. During the recession time, these companies faced with dips however recovered themselves very fast. During that time period, almost no change occurred in total employment where in the companies of the research, there happened employment increase.

Chart 1. ESCA Member Employment vs. Total U.S. Employment



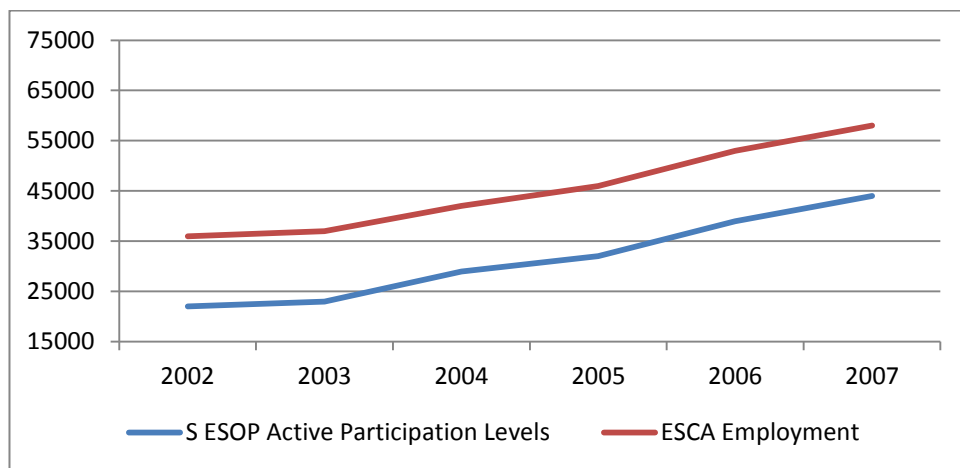
Source: Bureau of Labor of Statistics and Employee Owned S Corporations of America

The main source of the research is Department of Labor (DOL). This department takes all the necessary data and makes it publicly available via checking whether the company has employee stock ownership plan or any other benefit or retirement plans. In addition to the above information, this department also supplies North American Industry Classification System (NAICS) code. Moreover, in the research one major information needed, employer identification number (EIN). All the necessary data is collected in the database of the Bureau of Labor Statistics (BLS) and this data was used in order to analyze the companies. In the data of Form 5500, there were duplications and analyzing the data of the companies with less than 15 participants will make no sense. So, he removed these defects and generated the sample pool perfectly.

The analysis basically built on the philosophy that the number of the employees is strongly correlated with the number of participants and vice versa. The data basically does not include the actual employment number but the number of

participants in the plan. ESCA survey results are strongly correlated with Form 5500 data, approximately having the relation constant of 0,9. Chart 2 shows the relation of employment levels in ESCA and active participation levels of the companies in which S type plan is applied.

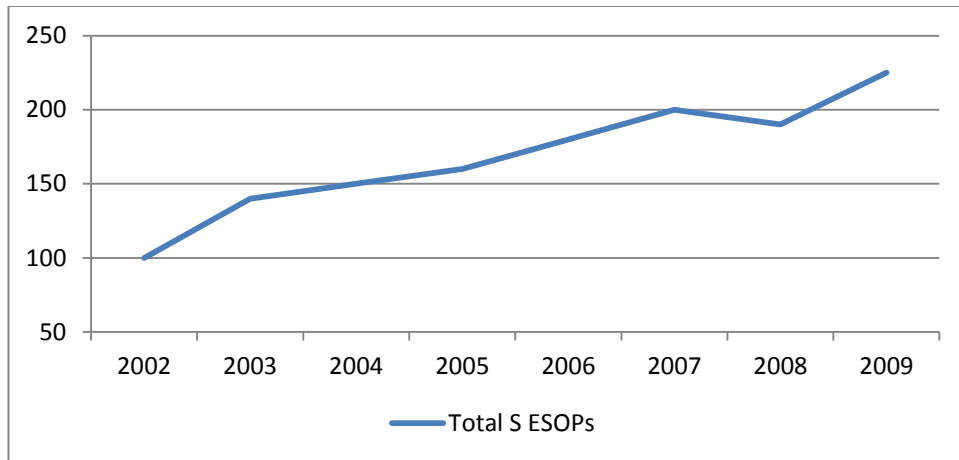
Chart 2. ESCA Employment vs. S ESOP Active Participation Levels



Source: Department of Labor and Employee Owned S Corporations of America

Active participation levels are approximately 40% lower than employment levels.

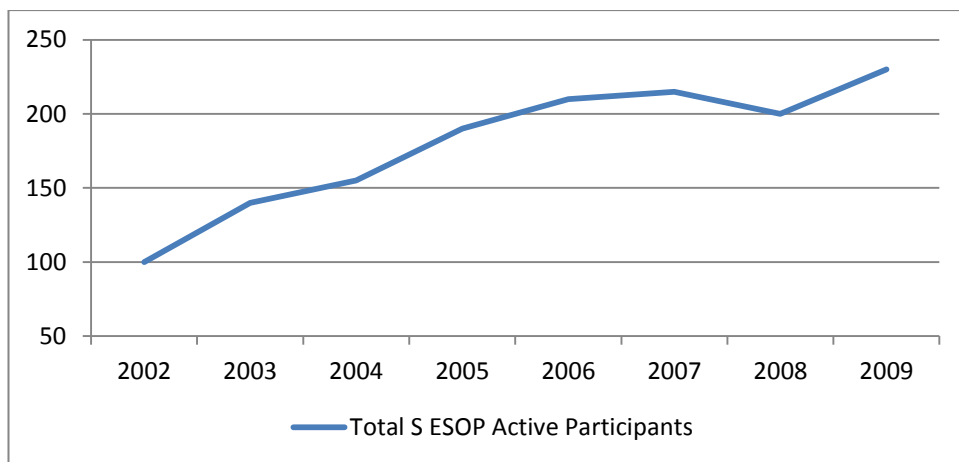
Chart 3. Total Number of S ESOP Companies (2002=100)



Source: Department of Labor and Employee Owned S Corporations of America

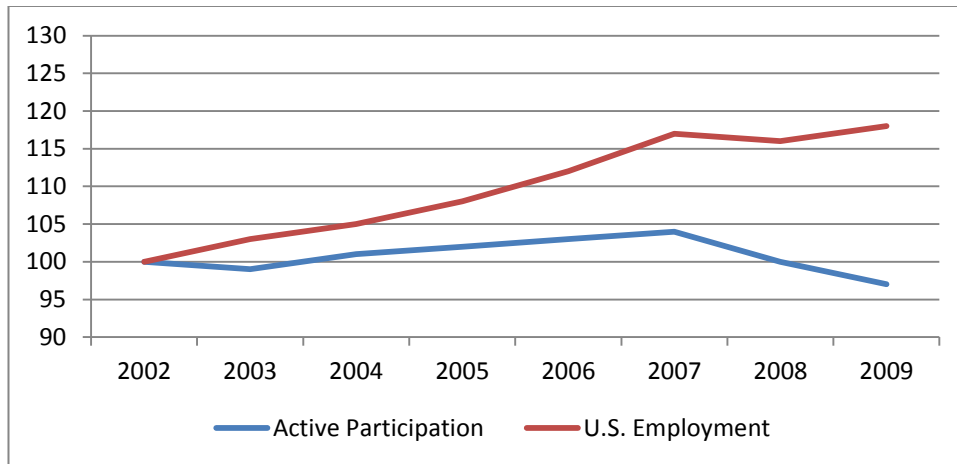
As expected, active participation has also doubled since 2002 and the decrease during 2008 period is because of the recession during that time.

Chart 4. Total S ESOP Participants (2002=100)



Source: Department of Labor and Employee Owned S Corporations of America

Chart 5. Active Contributors of S ESOPs vs. U.S. Employment (2002=100)



Source: Department of Labor and Employee Owned S Corporations of America

2.4.THE PERFORMANCES OF THE EMPLOYEE STOCK OWNERSHIP PLAN COMPANIES IN THE RECESSION

Recession times are extraordinary situations and in order to define weaknesses and strengths of an ownership plan, these times must be analyzed in detail. In terms of growth in revenue, retirement plans quality and job creation; non-S-ESOP companies did not manage to be successful as S-ESOP companies due to a research conducted in 2008, during the recession period. Moreover, these companies paid higher wages on average and keep on hiring workers during recession. S-ESOP firms derive productivity improvement with a direct ownership plan via aligning worker and employer interests also encouraging commitment and motivation.

During the time of recession, only 50% of the employees in America worked for an employer who serves them a retirement saving plan and unfortunately only 40%

of the employees in America participated in such retirement plans. ⁽¹⁴⁾ 60% Americans rely on only Social Security plans. Adding to these, 80% percentage of S type companies offer their employee retirement saving alternatives adding to Employee Stock Ownership Plan and also force employers to make contributions to these retirement plans. According to a research conducted by Employee-Owned S Corporations of America, in terms of full year performances in 2008, S Corporations achieved much more good results than non S-ESOP companies.

In the research, 49 S-ESOP companies' data were used from different types of the business. 24 firms of the research were from wholesale and retail business, 12 of the companies were from construction business and 13 of the companies were from manufacturing business. These companies were chosen in a way that they must have stock valuations, capital expenditures and compensations other than wage (retirement contributions such as employee stock ownership plan and side health benefits). According to this research, S-ESOP companies are much more successful than non S-ESOP companies in terms of creating & keeping jobs, paying higher wages & feeding personal retirement plans of the workers and supplying increase in salaries of the employees. Results can be classified in sub-headers:

14. Form 5500 datasets are available at www.dol.gov/ebsa/foia/foia-5500.html

Creating and Keeping Jobs: U.S. employment lost blood with 3.0% but in the companies applying the plan, the scenario was different, they increased their employment level by 1.9%. In construction the corresponding numbers are -9.1% and 3.0%. In manufacturing sector employment was flat in S-ESOPs where, there happened 6.4% of job loss had happened in non S-ESOP firms. Same performance is also valid for Services sector; S-ESOPs rose by 1.9% in 2008 where non S-ESOPs fell by 1.3%. (15)

Wage Growth per Worker: In terms of wage, both type of companies experienced wage growth but in the companies where this plan was applied, the growth rate was 5.9% where in other companies the growth rate was 3.2%. In construction, the case is similar as above, in the companies applying the plan, the growth is around 7.1% where this increase realized only by 3.3% in other U.S. companies.

The increase in manufacturing sector was 1.9% for S type companies, in comparison to a rise of 1.8% of non S-ESOPs. The gap is more significant in Services sector; increase in S-ESOP firms was 7.1% compared to 3.6% increase of non S-ESOPs. (16)

15. Douglas Kruse, Richard Freeman, and Joseph Blasi, National Bureau of Economic Research working paper 14233, August 2008

16. Employee Benefit Research Institute <http://www.ebri.org>

Higher Average Wages: In total U.S. sector, yearly wage for the employees was around \$31,600 where this value was realized in the companies applying the plan as \$50,225. It is also valid for manufacturing and services sector with earnings of \$55,600 and \$53,200 correspondingly, where the numbers for non S-ESOP companies are \$37,600 and \$29,900. For construction industry, wages are almost same for S-ESOPs and non S-ESOPs. (16)

Benefits: The only way to use the wages in a pleased way is having satisfactory benefit plans and the companies applying the plan can serve retirement plans and health benefits to make their employees enjoy the benefit. For all construction, manufacturing and services industries, growth of benefits were around 10% where non S-ESOP firms' growth rates are around 1%-2%. (16)

Firm Growth: The owners of the firms are employees in S-ESOP companies and since being the owner of the company provides clear incentives for employees, these firms achieve strong performances. In terms of revenue, S-ESOP firms grew by 15.1% in 2008 while non S-ESOP firms declined by 3.4%. (16)

As can be seen above, in the recession times, non-S-ESOP firms' performances did not manage to achieve good results. Where, S-ESOP firms preformed almost flawless and saved many employees. In terms of retirement plans, it can be seen that S-ESOP firms have been prepared for employees' retirement plan in a more dedicated way and promises good retirement days.

16. Employee Benefit Research Institute <http://www.ebri.org>

Table 1. Related Data of 2008 for S-ESOP Companies

	All industries	Building	Production	Other
Basic Properties				
Assets, \$mn	221,1	186,0	232,7	232,3
Gross Receipts, \$mn	376,0	488,6	326,4	346,5
Net Income, \$mn	22,2	24,4	38,0	12,6
Employment Benefits				
U.S. Employment	1329,0	1900,0	893,0	1279,0
Salaries, \$mn	68,4	83,9	50,1	70,6
Health, \$mn	5,5	4,5	4,6	6,5
Other , \$mn	1,7	1,4	0,9	2,2
ESOP Retirement				
ESOP Assets, \$mn	98,9	86,9	237,3	131,4
Contribution & dividends, \$mn	7,4	9,5	5,0	9,3
ESOP Participants	809,0	613,0	590,0	1025,0
Respondents	49	12	13	24

Source: Department of Labor and Employee-Owned S Corporations of America (www.dol.gov)

Table 2. Related Data of 2008 S Type Companies vs. U.S. Economy

	S-ESOP	Overall Economy
Job Growth, %		
Total	1,9	-2,8
Building	3	-9,1
Production	0	-6,4
Services	1,9	-1,3
Wage Growth, %		
Total	5,9	3,2
Building	7,1	3,3
Production	1,9	1,8
Services	7,1	3,6
Benefit Growth		
Total	11	1,9
Building	9,9	...
Production	12,5	0,9
Services	11	2,1
Retirement Contribution Growth, %		
Total	18,6	2,8
Building	17,4	...
Production	20,4	...
Services	18,9	...
Revenue Growth, %		
Total	15,1	-3,4
Building	35,1	-10
Production	3,5	-9,8
Services	9,9	...
Average Wage, \$		
Total	50.225	31.616
Building	43.457	43.791
Production	55.585	37.615
Services	53.223	29.881

Source: Department of Labor and Employee-Owned S Corporations of America (www.dol.gov)

2.5.THE CHALLENGES OF THE EMPLOYEE STOCK OWNERSHIP PLAN COMPANIES IN THE LONG RUN

Even before the formal authorizing law of Employee Retirement Income Security Act (ERISA) established in 1974, the very first ESOPs were already established. After the legislation of this act, number of ESOP companies grew steadily, today reaching 12,000. Some of the applied ESOPs have been working in parallel to this plan for over 30 years where in last years, the number of ESOP application and participation had increased. Analyzing these senior companies tell us a lot about the benefits, weaknesses and difficulties in order to assimilate the ESOP companies.

The main problem of the mature ESOP Company is accumulation of stocks and shares. Large-leveraged ESOP stock purchase that happened many years ago results in unfair distribution of stocks for new comers. Because of this reason, two types of employee arise. First one has high account balances and highly motivated for his company's success. They are also willing save and develop the saving. Second type employee will not see employee ownership as a good tool for retirement plan. The company's efforts to promote employee ownership will not be welcomed by this kind of employee; also sense of alienation may arise because of the first type of employee's attitudes to hold the high shares of ESOP. There are variety of things that can be applied in order to solve the problem and using correct tools simultaneously will help to solve the problem.

At the beginning, in order to buy stock, the money is needed and it is taken from the bank. It is held in the suspense account for a while and become available for the employees who have met all criteria of the plan. The mirror loan type is used in financing the ESOPs. ESOP company needs cash to buy stock and as an outside loan,

the bank loans money to company. If the company has its own cash then it creates its own loan for ESOP purchases. Banks strictly insist on repayment schedule to be finalized within 5 years for private companies but the company and ESOP can agree on longer payment schedule like 10 to 15 years. The capacity of suspense account is modified by the repayment schedule. As time passes, there will be many experienced participants of ESOP who are retiring so their shares will be available for recycling to less experienced workers. When the time comes for an employee to retire, there appears 3 different ways for his ESOP shares. In first scenario, company simply buys shares of the employee and retires the shares. This causes decrease in number of shares and worst way for the company to encourage new comers to ESOP system. In second scenario, again the company buys stocks and instead of retiring them, contributes them to the plan. In third scenario, even the ESOP does not have enough cash to buy shares, company helps ESOP to buy shares. In second and third scenario, ESOP recycles the shares which are bought from departing participants and these shares become available shares for the new comers. Retiring shares, instead of recycling them, will result in infelicity of the new comers and this is the biggest problem of the ESOP if it is not held properly by the ESOP. If 100% of shares of the ESOP is not held by ESOP, best way for the ESOP and the company is buying additional shares from non-ESOP shareholders until they reach 100% of shares. This achievement will solve main problems in major and it is the best way of fair share allocations to experienced workers and new comers.

In many years, retiring employees sell their shares to newcomers but if it is not the case? What should a mature ESOP company do to balance share allocation? The easiest way for this problem is printing up new shares and contributing them to ESOP. This move basically increases cash flow and makes tax deduction available in

parallel with making new shares available to new comers. But, as the number of shares increase, price of shares decrease and it will make both newcomers and experienced workers unhappy. So the company must be very careful when using this tool. If in the given year, there is no enough shares to be allocated to the employees, the company can also choose cash and rebalancing method. The procedure basically starts with the standard addition of the company to ESOP. This added cash is distributed fairly to the employees in terms of the solution procedure of the company. As a result, new comers will have no stock but cash in hand. For example, consider a new comer whose account has 100% shares. At the beginning of cash and rebalancing process, he has only 1% of stock and 99% of cash. On the contrary, experienced employee has 99% of stock and 1% of cash. This process mainly targets to stabilize accounts of the participants in terms of cash and stock. At the end of the process, veteran employee has 95% of stock and 5% of cash. Since the account of veteran employee is much more major than newcomer, decrease of the 4% stock in this account helps other newcomer's accounts to be stabilized at 95% of stock and 5% of cash. But in this case, what if the group of veteran employees decides to retire? This means there will be large number of stocks to be repurchased. The company also has to balance this situation. As mentioned earlier, the best way to handle these shares is contribution of the company to ESOP but redeeming shares with a new inner loan can also be a solution for this problem. Instead of supplying the needed money, the company can also give loan for purchasing. In this case, the important part is avoiding peaks with the plan of repayment of the loan. For example, if the number of the stocks to be repurchased is 20% of the total ESOP, it can be divided into 4 parts, roughly paying 5% of the loan in each year. It helps the company to avoid peaks and valleys in short term.

Many of the ESOP companies offer certain diversification opportunities to their employees, mainly required by the law. In order to have the opportunity of reinvestment with 25%, the criteria were being 55 years old and minimum 10 years of participation in the plan. The participants who meet these criteria can have the chance of investing stock back maximum to the quarter of the stock. There is no prohibition of an ESOP company according to law to modify the requirement of diversification. For example, the age criteria can be decreased to 50 or reinvestment to stock can increase up to 50%. With the help of expanding diversification opportunities, companies and ESOP can be supported much more by the employees. These exceptional situations can be made up for the talented or experienced people. For example, if the company is willing to hire a talented professional, it may not be enough to promise that he is going to become a participant in the ESOP if he is going to be patient and put in enough years. Also, restricted stock management or phantom stock management can be solutions for the handicap of this dynamic.

Overall, the plan brings many opportunities and many challenges to the company in which it is applied. Ownership culture, employee commitment and motivation in return bring outperforming company and employees. ESOP also improves wealth of the employees in terms of self-respect, personal dignity as the owners of the business.

3 SWOT ANALYSIS

i. STRENGTHS

1. All the employees in the system have the right to say a word in important subjects such as pricing, side benefits of the workers, earnings and salary, production planning and management. This system also balances delegacy and responsibilities in the Employee Stock Ownership Plan.
2. In terms of efficiency, this system clearly improves the efficiency of the company since every employee feels himself as the shareholder of the company and also loyalty of the employee improves with this system.
3. Improvement in efficiency directly increases the production and this increase in the production increases the salaries and earnings of the employees.
4. In this system, companies pay on the retirement plans and financing funds. Government guarantees the tax reduction for these payments with laws. This tax reduction system helps companies to get more cash money and companies can easily avoid taking credits from banks with high interests.
5. Employee Stock Ownership Plan basically built on the philosophy of 'The more you pay to retirement plan, the more you get when you retire'. Since this is guaranteed by law, each employee is willing to pay more to the finance of the company. This also helps the company to have a healthy financing system and prevents company to be purchased by other companies.
6. Retirement plan of the Employee Stock Ownership Plan pays back all the payments done by employees with more interest than any other financing tool so that each employee is encouraged by the company to invest much on the retirement plan.

7. In bankruptcy situations, government has to take the lead and rescue the company. This procedure is a hump on the shoulders of the government. With the help of this system, company can rescue itself via effectuating Employee Stock Ownership Plan.
8. In the long run, this system will be widely used and inflation will be prevented with this mechanism.

ii. WEAKNESSES

1. Every employee who takes part in the system has to leave the system eventually and when the time comes, company has to pay the earned rights and money. But what if large number of employees decides to retire? In this situation, company can become shaky and will have problems when paying the earned retirement money.
2. If the company does not have the 100 percent of the shares, it can become inadequate while defining the values of the shares of the company.
3. Most of the ESOPs have the criteria of a) Minimum 10 years of participation in the system, b) Minimum age of 55 years old c) Reinvestment up to 25% of the stock in their account, to have opportunity for early diversification. If this condition is applied strictly, it will be a problem in terms of creating recycled shares.
4. ESOP companies mostly have difficulties in keeping talents in the company since the system is basically built up on the 'length of service' basis. System has some difficulties in differentiating talents from regular employees.

iii. OPPORTUNITIES

1. In many Employee Stock Ownership Plans, employees who have been working for the company less than 2-3 years cannot have right to participate in this plan. Creating 'Recycling Shares' will be an opportunity for this situation. Making the retired shares available to new employees will help the company to pay the retired employees' post-retirement gratuity.
2. In order to solve the Weakness 2, the company can have contribution of new shares. The addition of the new shares will result in decrease in the values of the shares. The company must use this alternative very carefully.
3. If the conditions in Weakness 3 are applied strictly in the system, it will be the weakness of the system. If the ESOP becomes flexible in terms of the diversification conditions, it can become an opportunity for the system.
4. Creating stock options like phantom stock or restricted stock can be an opportunity to keep talents in hand.

iv. THREATS

1. Employee Stock Ownership Plan helps government in bankruptcy situations but it also cancels out the need of the government and these organizations become partially independent. In these situations at some point, the government will probably make a defense to new plans.

2. If the company becomes a highly demanded place, there appears a risk of self-interest. Shareholders want to keep their shares in hand and there will be lack of shares for new comers. Yet, it can be solved easily by the management's attitude and management's alternative solutions.

3. In the long run, there appears the risk of overcoming by drowsiness. It can also be solved by management attitude and solution alternatives.

4. CONCLUSION

Louis Kelso generated the world's first employee stock ownership plan in 1956 to build up the most efficient way of transferring shares to the employees. He believes that, the most logical buyers and ultimate owners must be company's employees who play the major role in successful business and who know all the handicaps of the business. Because of the lack of alternatives, in next several years the ESOP may be the best alternative buyer available to owners of the many privately held companies. The plan has many flexible points and it can be used in favor of both buyer and employees. For example, any seller can sell his stocks and still keep control of the company. If the finance is done via seller note, he does not need to sell the stock and take back the seller note. He can also sell stock to the employee stock ownership plan till he balances his shares. . In terms of growth in revenue, retirement plans quality and job creation; non-S-ESOP companies did not manage to be successful as S-ESOP companies due to a research conducted in 2008, during the recession period. Moreover, these companies paid higher wages on average and keep on hiring workers during recession. S-ESOP firms derive productivity improvement with a direct ownership plan via aligning worker and employer interests also encouraging commitment and motivation.

All the employees in the system have the right to say a word in important subjects such as pricing, side benefits of the workers, earnings and salary, production planning and management. This system also balances delegacy and responsibilities in the Employee Stock Ownership Plan. In terms of efficiency, this system clearly improves the efficiency of the company since every employee feels himself as the shareholder of the company and also loyalty of the employee improves with this

system. Improvement in efficiency directly increases the production and this increase in the production increases the salaries and earnings of the employees. Moreover, ESOP companies mostly have difficulties in keeping talents in the company since the system is basically built up on the 'length of service' basis. System has some difficulties in differentiating talents from regular employees where creating stock options like phantom stock or restricted stock can be an opportunity to keep talents in hand.

In Turkey, few attempts very similar to Employee Stock Ownership Plan were done but still there is no company exists in Turkey, fully applying Employee Stock Ownership Plan. Turkish legacy system does not support this system and becoming shareholders in classical methods is the only solution for now. In this paper it is emphasized that this system works well and has strengths which help company to improve performance, make more revenue and supply employee satisfaction. Also in recession situations, this system rescued many companies. If the Turkish government facilitates this system especially in legislation side and supports credits to people who want to apply this system to their company, there will be many attempts and it also helps productivity and GNP of the country.

Finally, Turkish government has been supporting Personal Retirement Plans with 25% Government Support and according to the Personal Retirement Plan data; the number of participants has been exponentially increasing. If Employee Stock Ownership Plan can be supported by the government, it will also help people to build up their own Personal Retirement Plans in an alternative way.

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