9 The Psychology of Employee Owners

Why Launching New Employee Ownership Schemes Can Signal Organizational Resilience During Crises

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In this chapter, the authors examine one resilience signal – the launch of a new Employee Stock Ownership Program (ESOP). They propose that the decision to launch a new ESOP not only conveys to external stakeholders, especially capital markets, what top managers think about the prospects of the firm but also provides information about what the employees, who often have first-hand knowledge of the state of the firm, think about the future prospects of the firm and their willingness to invest their own capital in building a sustainable future for the business. This chapter contributes to our understanding of how managerial actions that enable employees to increase their ownership stake in the organization can be a resilience signal, and it draws upon organizational research in signaling theory, stakeholder theory with an emphasis on changes in ownership, and research on the psychology of ownership and employees' actions based on their outlook on the firm.

Introduction

The study of organizational resilience and the long-term sustainability of businesses has emerged as a major topic of research – especially in times of economic turbulence (Di Fabio, 2017; Rai et al., 2021; Shepherd & Williams, 2022). Organizational resilience – the ability of an organization to successfully cope with a crisis – is a systemic property of the organization. It is a combination of factors, such as strong culture, operational efficiency, robust supply chains, and close relationships with external stakeholders, that allow organizations to generate additional resources when they face threats to their viability (Christianson et al., 2009; Salanova et al., 2012). In this context, organizational sustainability refers to how an organization balances short- and long-term needs as it builds "the present in such a way as not to put the future at risk" (Di Fabio, 2017, p. 2).

During a crisis, external stakeholders, such as customers, suppliers, or external shareholders, pay close attention to how an organization responds to the challenges. As they do not have complete information, they rely on information signals generated by managerial actions that are salient to the organization's ability to recover from the crisis – therefore, indicating resilience (Sanders & Boivie, 2004; Musteen et al., 2010). Such decisions generate what we shall call 'resilience signals' because they provide information about the strength of the organization when facing threats to its viability and long-term sustainability.

In this chapter, we examine one such resilience signal – the launch of a new Employee Stock Ownership Program (ESOP). We propose that the decision to launch a new ESOP not only conveys to external stakeholders, especially capital markets, what top managers think about the prospects of the firm but also provides information about what the employees, who often have first-hand knowledge of the state of the firm, think about the future prospects of the firm and their willingness to invest their own capital in building a sustainable future for the business (Pierce & Rodgers, 2004; Wagner et al., 2003). Using concepts in signaling theory, we further argue that external shareholders would perceive the launching of ESOPs during a crisis as a proxy of organizational resilience since it meets key conditions set out by the theory: (a) the launch and magnitude of employee uptake of the ESOPs are publicly reported and, hence, are easy to observe externally; (b) the launch of an ESOP carries potential penalty costs for a firm in terms of damage to the perception of resilience if the offer is not taken up by employees, and likewise, there are potential costs for participating employees if the firm does not recover its valuation; and (c) launching ESOPs meets the condition for effective signals by creating a separating equilibrium between resilient and non-resilient organizations (Bergh et al., 2014).

This chapter contributes to our understanding of how managerial actions that enable employees to increase their ownership stake in the organization can be a resilience signal (Van Der Vegt et al., 2015; Williams & Shepherd, 2016; Williams et al., 2017). To build our argument, we draw upon organizational research in signaling theory (Bergh et al., 2014; Connelly et al., 2011), stakeholder theory with an emphasis on changes in ownership (Donaldson & Preston, 1995), and research on the psychology of ownership and employees' actions based on their outlook on the firm (Pierce & Rodgers, 2004; Babenko & Sen, 2015; Luthans et al., 2007).

Theoretical Background

Organizational Resilience

Developed by ecological system theorists, resilience is a measure of "the persistence of systems and of the ability to absorb change and disturbance and still maintain the same relationships between state variables" (Holling, 1973, p. 14). More recently, organizational theorists extended the concept to organizations, focusing attention on resilience as the ability of some organizations to absorb the impact of a crisis (Van Der Vegt et al., 2015).

Researchers have identified a variety of mechanisms that allow firms to develop resilience (Sabatino, 2016). These include developing managerial competencies that enable decision-makers to respond quickly to crises situations (Lengnick-Hall et al., 2011), positive affect and transformational leadership (Sommer et al., 2016), developing 'healthy' organizational resources and practices (Salanova et al., 2012), learning from rare events that improve the organization's ability to deal with future crises (Christianson et al., 2009; Lampel et al., 2009; Williams et al., 2017), evolving organizational capabilities that allow organizations to reconstruct activities during environmental change (Hamel & Valikangas, 2003), capabilities for rapid change (McDonald, 2006), designing enterprise systems that absorb shocks such as redundancies in supply chains (Christopher & Peck, 2004), and engaging in business continuity planning that prepares organizations for disruptions in critical systems (Riolli & Savicki, 2003). These mechanisms are internal to the organization. Their relative strength can be assessed by managers as well as employees, who can observe operations on a day-by-day basis, but they are relatively invisible to outside observers. Furthermore, assessing whether these mechanisms confer resilience on the organization is, normally speaking, not a top priority for these observers unless the viability, if not very the survival of the organization, is at stake.

Signaling Theory and ESOP as a Resilience Signal

Signaling is essentially concerned with reducing information uncertainty in interactions between two parties – where one party (receiver) relies on the actions of another party (sender) to credibly infer certain information about it (sender). For instance, in a job market recruiters need to make assessments about the abilities of applicants. In this situation, recruiters can consider an applicant's educational attainment as a signal of their abilities. The credibility of the signal lies in the recruiter's belief that educational achievement is correlated with ability, allowing them to distinguish between applicants with high and low abilities (Spence, 1973, 2002). Management scholars have used this theoretical lens to explain decision-making under information asymmetry in several contexts across strategic management, entrepreneurship, and organizational behavior (Connelly et al., 2011). For instance, Turban and Cable (2003) use signaling theory to show that students in business schools use a firm's reputation for socially responsible practices as a signal of that organization's working conditions. They show that this is reflected in the higher quality and quantity of job applications to firms with higher reputations.

It is worth noting that in these examples, as in the case of resilience signals, the signal is not created for the receiver who interprets the signal. The educational attainment of applicants may reflect an interest in the subject rather than a signaling decision to a future employer. Organizations may engage in responsible social practices because managers subscribe to a set of values, rather than a conscious design to attract a certain type of employee. What is crucial for the receiver is whether the signal is credible, not whether it was intentionally created or whether it distinguishes between parties that have or do not have the desired characteristics.

During crises, external stakeholders pay more attention to organizational resilience, making them particularly sensitive to resilience signals that convey information about the organization's ability to deal with the crisis (Abrahamson & Park, 1994). Such signals are not necessarily created by managers with the primary purpose of conveying resilience, but they are often the by-product of actions that address other issues facing the organization. Nevertheless, actions that are undertaken purely for organizational purposes may contain information that external stakeholders may find useful when it comes to assessing the resilience of the organization as a whole. The usefulness, however, will depend on the relationship of the external stakeholders to the organization: suppliers may be sensitive to a potential fall in demand that may affect the ability of the organization to meet its payment obligations; buyers of products that require long-term servicing may be focused on the survivability of the organization; and shareholders are likely to pay close attention to any changes in the firm's financial structure during a crisis, as this will negatively impact their own investments.

A key premise of this theory is that external shareholders are keenly aware of the information asymmetries that exist between their knowledge about the firm and the knowledge that is available to organizational insiders (Petit, 2007). It is important to bear in mind that signaling theory makes a distinction between the observability of signals and their credibility. Signals must be observable to be interpreted accurately, but they will not be taken as credible unless they are costly to produce (Spence, 1973). An illustration of a costly signal that observers are more likely to take seriously is quality certification programs, such as ISO 14001. As Montiel et al. (2012) demonstrate, to become ISO 14001 certified firms must comply with strict, costly quality and environmentally responsible practices. In essence, the upfront costs of implementing ISO 14001 make it a credible information signal to stakeholders in general but, in particular, for customers that seek information on which firms produce quality products and are environmentally responsible and which firms do not. The precise reasons that motivate firms to implement ISO 14001 are less important to external stakeholders than the fact that the organization is willing to bear the upfront costs associated with the program, since motivations may vary. Firms may wish to outdo their competitors in a reputation for quality or merely avoid falling behind the rest of the industry. Regardless of the motivation, these upfront costs lend legitimacy to the information signals and credibly confirm the program's substantial impact on the organization.

In addition to discussing information signals that are credible because they involve upfront costs, signaling theory also argues that information signals can be credible when they do not involve significant upfront costs but, instead, communicate future scenarios that can impose substantial penalties on the decision-maker. For example, when a CEO buys shares in her own company, external shareholders see the move as a credible signal of a higher probability of positive future performance. They take this view because they assume that the CEO, a rational self-interested actor with insider knowledge of the firm, will not take this risk if there was a significant probability of the firm doing poorly in the future (Jain & Tabak, 2008). In other words, they attribute credibility to the information signal generated by the action of the CEO because such an action creates potential costs for the CEO if the actual state of the firm turns out to be much worse than what management discloses to the market in its current business announcements and formal financial reporting. This assumption gains even greater credibility during a crisis, when the CEO's or top management's purchase of shares occurs during a downturn. A downturn confronts the CEO and top management with a stark choice: they can preserve their personal wealth by acting in a manner that is consistent with their knowledge of the state of the firm, or they can behave inconsistently and suffer substantial financial losses. From the point of view of external shareholders, therefore, personal purchases of shares by top-management insiders during a downturn generates credible resilience signals because these actions represent an undertaking of personal risk at a time when the organization confronts conditions that will test its ability to deal with the crisis.

ESOP Adoption as a Signal of Employees' Insider Knowledge

Insider knowledge of how well a firm can cope with a severe economic crisis is not just confined to the CEO or even top management. Employees who deal with daily operations and interact with customers are often the first to see problems and strengths that influence an organization's future performance. For instance, Babenko and Sen (2015, p. 1878) argue that lower-level employees often have information about the prospects of the firm, such as future sales growth and innovation. They show that "aggregate purchases of company stock by lower-level employees predict future stock returns" and, crucially for our argument, their analysis also suggests that the relationship between employees' stock purchases and future stock returns is stronger in firms where employees are likely to have a greater informational advantage over external shareholders when there is less publicly available information – notably, in the case of smaller firms, in firms that are followed by fewer analysts, or in times of crisis when information asymmetries are likely to rise.

Studies of the influence of employees' equity ownership, such as those carried out by Chang (1990), Faria et al. (1993), and Beatty (1995), demonstrate a positive influence of the level of employee ownership on shareholder value. In contrast, other studies, notably Gordon and

Pound (1990) and Poulain-Rehm and Lepers (2013), failed to detect an influence of employee ownership on shareholder value. A comprehensive analysis of studies on this issue by Blasi et al. (2003, pp. 155–157) analyzed seventy empirical studies, effectively all studies published on the topic at that time. They found that the evidence of a positive influence of employees' equity ownership is exceptionally strong. Indeed, the evidence is so strong that they concluded with the observation that the "results surprised even us, not because they were so positive, but because they were so extensive and so uniform. Investors came out ahead if their company adopted key elements of partnership capitalism."

Extant evidence that shares of firms with employee ownership perform better in equity markets is based on normal trading conditions. By and large, this evidence supports the hypothesis that external shareholders view a certain level of employee ownership as correlating with better long-term share performance. During crises, however, investors are much more concerned with the firm's near-term ability to avoid debilitating losses rather than long-term returns. Here, too, research suggests that employee ownership can make a positive contribution to a firm's longevity. Blair et al. (2000) track publicly traded companies from 1983 to 1995, finding that companies with substantial employee stakes are 20% more likely to survive in their respective industries. Park et al. (2004) track data from all U.S. public companies from 1988 to 2001, finding that employee-owned firms disappear at a slower rate and, hence, are less vulnerable than non-employee-owned firms, which disappear at a faster rate. In a more recent study of firm performance from 1999 to 2011, which covers the last two recessions, Kurtulus and Kruse (2017) also argue that employee-owned businesses provided more stable employment and were more likely to survive the crises.

To sum up, evidence shows that the level of employee ownership is a predictor of future financial performance and, hence, also a predictor of long-term share performance. During a crisis, the level of employee ownership is also a good predictor of the firm's ability to address the issues that arise as a result of the crisis. Building on this body of evidence, we propose that, keeping everything else equal, an increase in employee ownership during a crisis by launching a new ESOP can generate a signal of organizational resilience. We use the response of external shareholders to test this proposition. What is important to bear in mind is that we are not arguing that firms strategically use ESOPs to influence the behavior of external shareholders. Rather, in line with signaling theory, we argue that ESOPs are launched primarily for organizational reasons and, thus, constitute an unintentional rather than an intentional signal (Vasudeva et al., 2018).

In the following section, we derive three propositions that are based on this argument that launching new ESOPs is a resilience signal. First, we argue firms that launch new ESOPs during a crisis would have more resilience. Second, if the signal has greater salience in times of a crisis, a key part of our argument is that organizational resilience is more relevant in times of crisis compared to relatively normal times. Third, we argue that the credibility of the signal to external shareholders is proportionately greater if it comes from firms that have lower levels of employee ownership rather than firms that are already largely employee owned.

Propositions

Our central argument in this chapter is that the action of launching an ESOP is a resilience signal that provides information on organizational resilience to external shareholders. The signal is particularly meaningful during a crisis, when the solvency of the organization, and hence resilience, is of salience to external shareholders. Therefore, if launching an ESOP communicates resilience during a crisis, external shareholders are more likely to view firms that launch ESOPs more positively than firms that do not.

Separating Equilibrium Due to ESOP Launch

As discussed before, external shareholders are attentive to any changes in the equity ownership by internal employees. If employees buy shares in the firm during the crisis, it is likely to indicate employees' confidence in the resilience of the firm; conversely, if employees sell their equity stake or are given an opportunity prefer not to increase their equity stake, it is likely to indicate their lack of confidence in the firm's ability to recover. External stakeholders can form their own assessment of the resilience of the firm by obtaining readily available information on insiders' share purchases. Information on ESOPs is routinely made available to external shareholders via investor reports. A firm's decision to launch ESOPs and employees' subsequent decisions to purchase or decline to purchase shares through an ESOP are therefore visible to external shareholders because such schemes are launched formally and openly, and the uptake by employees is noted publicly.

Launching a new ESOP, therefore, meets the first and second conditions for credible signaling stipulated by Bergh et al. (2014). The first is clear signal observability, and the second is costly signaling due to potential penalty costs on both the firm and employees should uptake of the ESOP offer fail to meet expectations. The two conditions must work together. In other words, the launch of an ESOP on its own will not communicate a strong organizational resilience signal unless it is clear to external shareholders that the firm will incur potential penalty costs in the form of lower share prices should employees decline to participate in the ESOP.

A board's decision to incur the costs of launching an ESOP and employees' uptake of the share offer are together, therefore, a credible resilience signal precisely because, during a crisis, both the board and employees risk exceptionally high penalty costs – the board by virtue of its fiduciary responsibility to shareholders, and the employees because the firm's failure will wipe out their own investments. Put differently, neither the board nor the employees would participate in a new employee ownership scheme unless they were confident of the firm's ability to deal with the crisis.

Bergh et al. (2014), however, point out that although potential penalty costs may be necessary, they are not sufficient to ensure the credibility of a signal. For the signal to be useful to shareholders, it must create a 'separating equilibrium' – a relative difference in the market valuation of firms that launch ESOPs and those that do not. In the context of a crisis, if the launching of a new ESOP is a resilience signal, then everything else remains equal, and external shareholders are likely to view the prospects of firms that launch new ESOPs more positively than firms that do not. Therefore, our first proposition is the relationship between the launching of a new ESOP and organizational resilience:

Proposition 1: During an economic crisis, only firms with greater resilience would launch new ESOPs. Therefore, the launching of an ESOP can be a resilience signal.

The Salience of Launching an ESOP During a Crisis and Normal Conditions

Extant research argues that a signal's salience depends on the context in which it is interpreted by a receiver (Connelly et al., 2011; Kotha et al., 2018). For instance, Davila, Foster, and Gupta (2003) argue that Venture Capital (VC) funding for an early-stage start-up is a signal of its financial need as well as quality. However, in the job market potential employees may still be reluctant to commit to a start-up that has not yet secured financing over multiple rounds. For potential employees, VC funding in a later stage is likely to have more salience, as they are more likely to be interested in joining the growth phase of the firm, rather than the start-up phase when risks may be greater. In essence, the same signal (VC funding) has more salience for a job applicant in a growth stage start-up than in an early-stage start-up.

Our first proposition argues that external shareholders are likely to view the decision to launch a new ESOP as a signal of employees' insider information about organizational resilience in the face of the crisis. In practice, this means that during a crisis ESOPs impact market valuation of the firm because external shareholders are attentive to solvency issues when making investment decisions. However, as we mentioned earlier, Blasi et al. (2003) suggest that firms that launch ESOPs during normal economic conditions have a higher market valuation relative to firms that do not act similarly. The difference between launching ESOPs during normal times and during crises is the importance of firm solvency. During normal economic conditions, solvency of a business in not a major concern and, therefore, external stakeholders' interpretations of the launch of ESOPs and its influence on share prices is less likely to be focused on solvency. In large part this is because employees with insider knowledge are less likely to consider immediate solvency as an issue when deciding on whether to buy into an ESOP. Instead, as researchers have suggested, in normal times employees' decisions to participate in ESOPs are motivated by various reasons, such as trust in corporate governance, tenure with the firm, exit intention, long-term retirement savings, or even knowledge of future product launches (Babenko & Sen, 2015; Caramelli & Carberry, 2014). Therefore, during normal conditions, while external shareholders, who are motivated to maximize returns, are likely to consider the launch of ESOPs as a positive indication, they are also likely to consider a variety of other measures to assess how the firm meets their own investment objectives. In essence, we argue that when firms face adverse business conditions, the launching of an ESOP becomes more credible as a resilience signal, as external stakeholders are far more focused on the risk of organizational failure and, therefore, are more sensitive to actions, such as the launching of ESOPs, which help them bridge the information asymmetry, and they need to assess this risk more accurately.

Putting the two together, we can compare the impact of launching ESOPs during normal times and during an economic crisis to determine its salience as a resilience signal. If ESOPs signal organizational resilience, and thus lead to greater market valuation, we would expect the gap in market valuation that exists between firms that are more and less resilient to increase when ESOPs are launched during an economic crisis. Put differently, during an economic crisis we would expect external shareholders to place an even greater significance on the launch of ESOPs than they would during normal economic conditions, thereby leading to relatively higher market valuation if they judge the information positively. This gives us our second proposition regarding the salience of the signal in times of crisis compared to non-crisis:

Proposition 2: The relative difference in resilience between firms that launch new ESOPs and those that do not launch new ESOPs will be greater during a crisis compared to non-crisis periods.

Credibility of New ESOPs in Relation to Existing Levels of Employee Ownership

Extant research on signaling theory argues that costly signals are more credible (Cohen & Dean, 2005; Connelly et al., 2011). Thus far, we have contrasted the response of shareholders to firms that launched ESOPs versus firms that do not launch ESOPs. However, the binary distinction does not take into account the level of employee ownership at the time of the launch of ESOPs. In our theoretical discussion, we point out that the potential penalty costs that employees may incur when purchasing shares play an important role in employees' willingness to take up the ESOP offer. Thus, the rate of ESOP uptake constitutes a resilience signal that is strong when a high percentage of the share offer is purchased by employees and weak when employees decline to take advantage of the offer.

Because the rate of ESOP uptake determines the strength of the resilience signal, it is a factor that top management must consider when deciding on whether to launch an ESOP. Moving ahead with an ESOP launch will therefore reflect risk assessment of the rate at which the ESOP offer will be taken up by the employees to whom it is offered. The existing level of employee ownership will influence this risk assessment: Employees that do not have previous experience with taking up ESOP offers are less likely to respond positively than employees that have purchased shares before and, therefore, are more familiar with the process. Thus, launching an ESOP in a firm where existing employee ownership is low poses a greater risk of low uptake than launching an ESOP in a firm where employee ownership level is high.

The willingness of top management to take this greater risk in terms of a higher penalty cost translates into shareholders perceiving the resilience signal as more credible relative to firms with high levels of employee ownership. This means that external shareholders evaluating ESOPs as a signal are likely to see an ESOP from firms with low levels of existing employee ownership as conveying more credible information about the resilience of the organization than firms with high levels of existing employee ownership. The judgement as to the credibility of the signal, it is worth emphasizing, is relative: shareholders may not necessarily conclude that the future performance of firms with low employee ownership that launch ESOPs is higher than firms with high employee ownership that launch ESOPs. But during a crisis, when uncertainty is high, they are likely to see the information conveyed by ESOPs launched by firms with low employee ownership levels as less ambiguous than the information conveyed by firms with high employee ownership. This means that during a crisis, investors are likely to view more favorably the launch of new ESOPs by firms with a lower proportion of employee ownership, indicating that the relative difference in market valuation between firms that launch new ESOPS and those that do not should be greater for firms that have lower proportion of employee ownership. This gives us our third proposition regarding the credibility of the signal:

Proposition 3: During a crisis, the relative difference in resilience between firms that launch new ESOPs and those that do not launch new ESOPs will be greater for firms with a lower percentage of employee ownership.

Conclusion

In line with current literature, we characterize the acquisition of equity by insiders as a proxy for insider knowledge that external stakeholders and shareholders can employ to make decisions. However, the nature of this knowledge and how it is interpreted is underspecified in the theory. We propose that, since resilience signals involve interpretations regarding a firm's ability to successfully deal with the crisis, it is qualitatively different from interpretations of insiders acquiring equity during normal business cycles. We propose that employees choosing to increase their equity ownership via ESOPs during a crisis is indicative of the underlying psychology of employee ownership – they believe in the long-term sustainability of the business. Under normal business conditions, external shareholders' schema focuses attention on potential profits that can shift share prices when processing information about ESOPs. On the other hand, when firms face adverse business conditions, external stakeholders are far more focused on the risk of organizational failure. They are therefore likely to regard the launching of ESOPs as a resilience signal because employees, who have first-hand knowledge of the organization's ability to sustainably recover, would not be willing to invest their own capital in the businesses.

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