Columbia Law School
The Center for Law and Economic Studies
435 West 116th St.
New York, NY 10027-7201

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The United Airline Bankruptcy and the Future of Employee Ownership

Jeffrey N. Gordon

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Abstract

The collapse of the UAL employee stock ownership experiment in UAL's bankruptcy does not demonstrate the inevitable failure of the institutional form any more than the collapse of Enron shows the impossibility of the large publicly held corporation. Rather, UAL suffered from particular design flaws in its stock ownership plan and, more seriously, the absence of complementary institutions focused on the distinctive problems of employee-owned firms.

Two episodes of employee stock ownership have been much in the news. The first of course is Enron's, in which employees who had invested their 401(k) retirement plans disproportionately in Enron stock suffered serious losses. But Enron's collapse was shortly followed by the bankruptcy of United Airlines, in which employees who owned 55 percent of United's equity through an ESOP suffered an even greater loss. Since I've written about the United employee buyout, [1] I want to reflect on what the apparent failure of the employee ownership experiment at United says about the future of employee ownership of the large public firm.

The question posed by the United bankruptcy is clear, but the answer is not. On the one hand., it seems wrong-headed to reject the potential value of employee ownership because of the failure of a single experiment, much as it would be wrong-headed to reject the large publicly held firm because of the failures of Enron, WorldCom and Adelphia. We shouldn't be distracted by the different sample sizes, yes? There are many publicly held firms of the traditional sort, but there is only one large public firm, United, of the employee owned sort, and so one shouldn't draw too rapid a conclusion. Yet the very problem with employee ownership, in a practical sense, may be that so long as the experiments are few in number, the flaws and potential pathologies that would surface in any new organizational form will not be worked out so as to make employee ownership a viable competitor to the traditional public corporation. In this regard I want to focus on some of the some of the failures of institutional design at United that were never remedied and, indeed, that render the ESOP a poor choice as the principle

1. Employee Stock Ownership in Economic Transitions: The Case of United Air Lines, 10 J. Applied Corp. Fin. 59 (1998) and in Klaus Hopt et al, Corporate Governance: The State of the Art and Emerging Research (1998).

employee ownership vehicle for the large public firm. Those who care about employee ownership need to think about institutional redesign rather than try to excuse the failures of this particular experiment.

Part of the case for employee ownership of stock, whether through a 401(k) plan or through an ESOP, is the supposed alignment of the interests of employees with those of the shareholders. This means that measures that increase the profitability of the firm, whether through increased revenues, cost reduction or other productivity enhancements, which bring benefits for the employee shareholders as well as the public shareholders, will be actively pursued by all concerned. So, it gives employees incentives to pursue profit-increasing measures and it shares the fruits of those successes with the employees.

There are distinct arguments on behalf of employee participation in *governance* that are not necessarily the same as the arguments for employee participation in *ownership*. For example, governance rights might lead to greater efficiency, perhaps through more information flow to the board of directors about managerial performance or about operational matters; governance rights might also promote enhanced employee morale, which itself has efficiency implications. (Of course, there is also an important set of social and political arguments separate from efficiency concerns that I don't need to rehearse here.) Some have believed that coupling governance with ownership would be particularly important and useful because of the relationship between governance decisions and employee welfare as measured in stock prices. On the upside, stock ownership connects good governance decisions to employee payoffs. On the downside, the disconnection of governance from stock-based claims creates the risk that cash flows will be diverted in favor of governance-claimants as opposed to equity-claimants, which will make outside capital hard to generate. That is, in the same way that we are concerned about the disaggregation of cash flow claims from governance claims in the public firm more generally, whether it's dual class common stock or pyramidal structures found in many European firms, those same concerns counsel us to be wary about the separation of employee governance rights from the cash flow claims arising from stock ownership.

The UAL experiment in employee ownership was launched by an employee buy-out of 55 percent of the United equity in 1994, financed by publicly issued debt and by employee concessions.[2] It ended in a bad way with the bankruptcy of UAL, amidst what appear to be a flurry of seemingly perverse actions by unions whose board representation should have given them a uniquely detailed, highly credible picture of the firm's financial distress. That is, what is particularly troubling is that the employees who were pursuing some of the strategies I'm about to describe were well-positioned to appreciate the consequences for the financial health of the firm. The employees were not dependent on management's representations and its potentially negative puffery. Instead, they were represented on the board itself and in this way had access to reliable information. The union directors were presumably educated by their board service as to the overall industry situation and United's relative position. Yes, the whole airline industry was hit hard by the recession and the post-9/11 fallout. Still, United had an enviable worldwide route structure and was highly profitable throughout the later '90s. By contrast, US Airways, which preceded it into Chapter 11, was only marginally profitable even in boom

2. *See* UAL CORP., 1996 ANNUAL REPORT 21 (1996).

times and was perennially hampered by a limited route structure.

Here is one event that I think captures some of the perversity: the pre-bankruptcy contract negotiations with the union, the IAM, that was (until recently) the bargaining agent for the company's mechanics, who, collectively, owned 15-20 percent of United's stock. The relevant contract with the mechanics became amendable in 2000, meaning, in the parlance of the Railway Labor Act, that the contract became open for renegotiation. This was the first such negotiation with the mechanics since the buyout and came after a six year period over which concessions accrued to finance the buy-out. The parties were unable to come to an agreement. They were unable to come to an agreement even post-9/11. The company accepted binding arbitration at that point, the union refused, and eventually President Bush empanelled a presidential emergency board which came up with certain proposed improvements to the company's initial offer.[3] The union authorized a strike in February 2002. Finally the parties agreed to terms, which provided for substantial wage increases, and improvements on what the presidential emergency board had suggested, all in the face of significant loss in air passenger traffic over the entire 2001 period and, of course, the drastic fall-off after 9/11. The union leadership that pursued this remarkable set of terms also sat on the board and knew full well the company's capacity (or lack of it) to shoulder the economic burdens.

In one sense, these events are understandable in light of the company's immediate history. The pilots also worked under an agreement that was amendable in 2000. They settled on their agreement sooner, receiving wage increases that made the contract the industry leader.[4] So, one might argue, why should United's machinists get anything less? If we're going to have to negotiate concessions, why not start from a higher base rather than a lower base. Nevertheless, the upshot was to increase the airline's cost per available seat mile from 9.4 cents per seat mile in 2000 to approximately 12 cents at the end of 2001,[5] which is to say more than a 25 percent increase over a very short period of time. These increased operating costs came at a time of rapidly declining revenues. When the then-CEO, a long UAL veteran, said that the company was headed for bankruptcy there was such an uproar on the part of the union directors, representing, after all, 55 percent of the equity, that he was forced out and was replaced by the present CEO, Mr. Tilton.[6]

Even now, bankruptcy, although an embarrassment, does not necessarily mean the end of employee ownership at United. First, there could well be a concessions-for-equity swap. Just recently, as part of the US Airways reorganization, such a swap resulted in the employees' receiving approximately 30 percent of the airline's equity on a full-diluted basis.[7] And indeed, since the United ESOP stock is a special class of convertible preferred stock, not simply common, the employees' equity position could be treated differently from the public shareholders. This could be seen as keeping the faith with the original employee owners and could be in addition to stock received in a concessions-for-

3. *See* Report to the President by Emergency Board 236, Nat'l Mediation Bd. Case No. A-13109 (Jan. 19, 2002), *available at* <http://www.nmb.gov/mediation/peb236report.pdf> (last visited June 1, 2003).

4. *See* Laurence Zuckerman, *United is Expected to Ask Its Employees for Cuts in Wages*, N.Y. TIMES, Nov. 30, 3001, at C1.

5. *See* UAL CORP. 10K REPORT, Item 6, *Selected Financial Data and Operating Statistics* (Mar. 8, 2002). "Available seat miles" is the number of seats per plane times the distance flown.

6. *See* Edward Wong, *United Air's Unions Offer Plan to Save Billion a Year*, N.Y. TIMES, Sept. 26, 2002, at 2C.

7. See US Airways 8-K, filed April 3, 2003, attaching press release describing terms of the company's restructuring and emergence from Chapter 11, available on the SEC's Edgar site.

equity swap.

But before plunging ahead with another experiment in employee ownership, it might be well to assess the structure of the original employee buyout as providing lessons about pitfalls to be avoided. My view is that there were two major flaws in the structuring of the original buy-out, foreseeable at the time, whose effects were made manifest by the recent financial distress. The first was the mismatch of cash flow rights and governance rights, and the second was the poor incentive alignment properties of stock contributed to the ESOP. As to the first, the mismatch of cash flow and governance rights: the employees received, first, convertible preferred stock that went into individual accounts in the ESOP (convertible upon retirement or discharge and only then alienable), and second, a special class of voting preferred stock carrying the right to elect directors.[8] This special voting stock, however, did not go to the employees or to the ESOP, but rather to the union leadership.[9] Thus the structure allocated cash flow rights to employee stockholders through their ESOP accounts and allocated governance rights to the union leadership.

Where the union membership consists solely of stockholders, and these stockholders vote for the union leaders, the separation of cash flow rights and governance rights seems formal rather than substantive. The employees need board representatives and selecting through union elections seems justifiable if not inevitable. After all, the unions (and the leadership) are the bargaining agent for the employees on all aspects of the employment relationship. The problem arises when, as occurred here, an original group of employees participate in the buy-out but subsequent employees do not, at a time of rapid growth. The United employee buy-in occurred during the 1994-1997 period and was paid for with concessions that accrued over that period. Employees hired in 1997, say, held much less stock than those on the payroll as of 1994. Employees hired after 1997 held no stock at all. In light of the front-loaded buy-in, the retirements over the period, and the relatively rapid growth of the airline in the late 1990s, a significant portion of the union membership was not "stockholders." A back-of-the-envelope calculation indicates that by yearend 2001, more than one third of the pilots and more than one half of the mechanics were not stockholders. In any event, the individual mechanic stakes were never very large. The result is that the union leaders must appeal for the votes of a substantial fraction of the membership who are not stockholders. In general employee ownership must address the temptation to use governance rights to extract more cash flow rights through the contracting process. As shareownership penetration decreases in the union membership, this becomes a much harder problem to manage. It may be that potential stock appreciation will justify wage demand restraint among employee owners, but that move will not work for employees who are not stockholders. The United buyout structure thus empowered union leaders needing to appeal to union members who would be increasingly indifferent to the stock price. The effect was a mismatch between governance rights and cash flow rights that has been value reducing in many other contexts and that became a particularly serious problem for the United employee buyout.

The second flaw was the problem of ESOP incentive incompatibility. Even in the case of a highly successfully firm, well-functioning employee ownership, and a soaring

8. UAL CORP. 10K REPORT, *supra* note 41, *Corporate Governance and the ESOPs*.
9. *Id.*

stock price, the stock appreciation is locked up in the ESOP. It's not available for consumption until the employee retires or quits. And so during the significant period that United's stock was doing quite well, it's easy to imagine the frustration of employees unable to realize the fruits of their stock ownership. In theory there is substitution among various forms of savings so that an increase in an ESOP account will be offset by reduced savings in other respects., making present consumption greater. Much of the empirical evidence on savings and consumption patterns conflicts with this theory, however. Thus, as a practical matter, United's employees did not see tangible benefits of their stock ownership.

Indeed, expecting ESOP stock to deliver significant economic incentives for line employees seems to contradict the "incenting" pattern for high level managerial employees who get stock options that vest over an exercise period of two to ten years and various other sorts of stock-based compensation and bonus payments that deliver near-term economic returns. There is a perverse twist to the comparative pattern. In light of their greater wealth and the declining marginal utility of money, high ranking managerial employees should be more favorably disposed to long term incentives – yet it's line employees who are given an appreciating asset that cannot be cashed out until retirement. Whatever its virtues in assuring that employees cannot readily divest themselves of their ownership position, ESOP stock does not make for an incentive compatible contract. It does not solve the problem that if employees do not derive near-term economic benefit from equity ownership, they are likely to employ their governance rights in ultimately self-defeating ways. This manifested itself throughout the history of United's employee ownership.

What are the conclusions? First, that institutions matter: those who favor employee ownership need to get beyond the ESOP form, which which won't work. The ESOP's tax advantages are a dangerous illusion, because saving money in the front end at the cost of creating a non-viable firm, means you haven't accomplished alot. The creative energy ought to be directed toward devising a structure that provides as durable form of employee ownership, which ESOP does, but nevertheless can deliver immediate value to employees that recognizes gains in the stock price that are in part attributable to their efforts and sacrifices. Such a structure needs to provide for a continuous employee buy-in as well, so that later-arriving employees also live with the incentives and constraints of equity ownership.

Yet there is a more pessimistic reflection that the United bankruptcy calls forth: that it may be not only that the United employee ownership experiment was a failure, but that the institutional complementarities necessary for the success of any ownership structure do not exist in the case of employee ownership. Thus if we rejigger things in the United reorganization, how likely is it that employee ownership will succeed?

To elaborate: Henry Hansmann claims that the problem with employee ownership is heterogenity of employees, and thus employee preferences, and thus the coherence of the employee objective function.[10] But why should that be a fatal problem any more than the

[10] Henry Hansmann, When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination,

the separation of ownership and control in the large public firm, or the “tunneling” and other private benefits extractable by a controlling shareholder of a public firm? Each of these can be fatal, but in the United States we have come to cabin the potential dangers through an array of complementary institutions, that is, institutions that interact synergistically. Shareholder capitalism is connected with many other institutions -- institutional investors, stock exchange listing requirements, SEC rules, fiduciary duties, various compensation arrangements -- all of which help control the various agency problems that come from the separation of ownership and control in the conventional public firm, or the different sort of agency problems that come from controlling shareholders. There is simply no comparable set of institutions for the employee owned firm. Unlike the Enron, WorldCom, and Adelphia set of cases, there are no institutions committed to observing and addressing the problems revealed by the United bankruptcy. That is, in absence of a critical mass of large employee-controlled public firms, there is not the experimentation with organizational forms and the pressures to change those forms midstream to address problems that arise. Many of the problems that proved fatal in the presence of financial distress were apparent early on at United. But there was no institutional mechanism to fix the problems because the deal was sui generis, solely a matter of contract. The more we examine corporate governance, especially in comparative context, the more we realize that it is the complex institutional set-up that makes a particular ownership form work. Reimagining and adapting those institutions for employee ownership may be the real challenge facing those who believe in the value of this ownership form.

And Economic Democracy, 99 Yale L. J. 1749 (1990).