United Airlines[1]

United Airlines is the largest majority employee-owned enterprise in the United States. In July of 1994, employees represented by the Air Line Pilots Association (ALPA), the International Association of Machinists (IAM), and non-union employees at United purchased 55 percent the company. United's flight attendants decided not to participate in the buy-out.

The terms of the ESOP included the following:

- Pilots and machinists accepted pay cuts ranging from approximately 12 percent to 15 percent, and non-union employees took 8.25 percent cuts in pay. The pay cuts last six years; they are scheduled to expire in 2000.

- Employees are guaranteed employment security for six years.

- Pilots accepted a two-tier wage plan, allowing lower wages for pilots who fly the United Shuttle.

- A "market hiring rate" (essentially, 50 percent below prior current hiring rates) was to be used in hiring future non-union, non-management staff.

- New recruits were to contribute 25 percent to their medical plan.

- ALPA, the IAM, and non-union employees each gained the right to appoint one member to the 12-member board of directors and to jointly select (with the CEO) four outside, independent directors. These governance provisions last as long as the employees own at least 20 percent of the company's stock. Given this provision, this governance structure should stay in place until approximately 2019.

The United case illustrates the potential of an ESOP for providing employees with a voice in key governance structures and processes, as well as in the strategic direction and decisions of a firm. However, as the analysis below suggests, it also illustrates that a voice in the governance process is not sufficient. Unless that voice is matched by changes in the workplace culture and practices and in labor-management relations and processes, the potential of the ESOP to add value to the firm and to meet employee expectations and interests is unlikely to be realized.

Four years after the creation of the ESOP, its record is mixed at best. On the one hand, company profits have increased and the value of the stock has increased. But these improvements mirror those of other airline companies. Labor relations have not changed significantly, and there is little evidence that employees enjoy greater involvement and voice in the day-to-day issues that affect them or that influence operational indicators such as on-time performance, customer satisfaction, or productivity. Cultural change efforts, it might be argued, have been largely symbolic and incremental rather than systemic. In the case of supervisors, their reductions in numbers and changed role may have had negative results. On the other hand,

[1] This case is contained in, "Rebuilding the Social Contract at Work: Lessons from Leading Cases," Thomas A. Kochan, Institute for Work and Employment Research, MIT Sloan School of Management, Task Force Working Paper #WP09, May 1, 1999. The longer article, including bibliographic references and footnotes omitted from this version of the case, can be found in the CasePlace.org References section.

employment security has been maintained, and union representatives have influenced a number of critical decisions, including the selection of the CEO. The long-term future of the ESOP rests on how the parties address several critical challenges facing them in the next two years, including choosing a new CEO, renegotiating their collective bargaining agreements, and deciding whether to extend ESOP provisions into a second generation.

Key Events

Several events in the history of United's employee-ownership arrangement highlight its strengths and weaknesses: the 1985 pilot negotiations; the ESOP deal itself in 1994; the 1997 wage reopener; the passenger service agent organizing campaign; the regional jet negotiations; the flight attendants' negotiations in 1997; the issue of rest time for pilots flying 777s on Pacific routes; past and future leadership succession; and the renegotiation of bargaining agreements and the ESOP.

1985 Pilot Negotiations

A 1985 strike by United's pilots set the stage for the series of events leading up to the 1994 ESOP. The lesson management drew from the strike about the power of the pilots continues to influence thinking within the firm today. The effects linger in residual distrust between the union and management, as well as between political factions within the union. The issue at hand during the 1985 strike was largely the company's demand that pilots accept a long-term, two-tier wage agreement that would allow United to compete on short-haul flights, especially on the West Coast. The union rejected this proposal and, while it agreed to a modified two-tier provision, the pilot's success in shutting down the airline and forcing a compromise signaled their considerable bargaining power to management.

Shortly after the 1985 strike, CEO Richard Ferris initiated United's short-lived effort to diversify the company and make it a "full-service" travel business. He bought Hilton Hotels and Hertz Rent-a-Car. This diversification effort was strongly opposed by the pilots and led to their first bid to buy the company. While the bid failed, it sparked a shareholder revolt against Ferris and his diversification strategy—leading to his resignation and the sale of both Hilton and Hertz in favor of refocusing on the airline business.

Between 1987 and 1993, the pilots made three additional efforts to engineer an employee buyout of the airline. Only the fourth effort was successful. Unlike the first three buyout efforts, the IAM joined the pilots in the buyout proposal.

The ESOP Deal

As the terms summarized above indicate, the ESOP negotiations focused on the financial aspects of the deal. According to one management official, this narrow focus is a major cause of many problems the parties have encountered later—in plain terms, the deal failed to address the people and relationship issues up front:

> "Deal makers (investment bankers) drove the process and collective bargaining issues and relationship issues were not given adequate consideration. They didn't think of any of these. The focus was on the "deal"—the financial aspects of

> getting it done. No consideration of how the four parties (management, IAM, ALPA, and non-union employees) would have to deal with each other. Indeed, some promises were made about collective bargaining relationships that created expectations that were not met because the people who made them were no longer around to deliver on them.
>
> This created two problems: The parties started their ESOP without clear expectations for what kind of relationship would be needed to make it work, and (2) the parties started with the mistaken expectation that behaviors would change on both sides just because of the ESOP."

Moreover, the motivations of the many groups involved in the ESOP were different. ALPA was the moving party and was interested in gaining a voice in the governance process and some control over the strategic direction and decisions of the firm. The IAM, on the other hand, was primarily interested in gaining job security. The non-union employees had no representation in the ESOP negotiations. Some of these employee expressed frustration over having the ESOP forced on them.

In the first year of the agreement, new CEO Gerald Greenwald was hired with the unions' support. Greenwald stated he was committed to spending up to 50 percent of his inaugural year with employees and made strong statements about the importance of empowering employees and gaining their input. However, expectations for what the ESOP meant for managers or how employees might act as owners were not clarified or communicated in a clear way. Things appeared to be going well, however, as financial and on-time performance improved.

A number of separate efforts were initiated in the first few years of the ESOP to change United's workplace culture. These efforts included culture change workshops (Culture Leadership Training, or CLT) and a range of other communications programs (for example, one was known as Mission United). But, according to both an internal management assessment and a case study of United performed by an outside consulting firm, these efforts were neither systematic nor reinforced in day-to-day operations. They therefore achieved little or no change. Given the heightened expectations associated with the ESOP, the lack of follow-through may have increased employee skepticism and/or disappointment. One case study stated the effects in the following way:

> It is true that a number of important steps were taken in the two years following the deal to promote a culture more oriented towards productivity improvement. But the evidence is that, for one reason or another, those efforts were not sufficient to change attitudes very much (Oakeshott 1997).[2]

The 1997 Wage Reopener

The 1997 wage reopener demonstrated that the low level of trust that existed between the unions and management had continued. These negotiations also left the impression that labor relations had not changed. By the time that the wage reopener

[2] See the Working Paper in which this case is embedded, "Rebuilding the Social Contract at Work," in the "References" section of the CasePlace.org website, for full references and citations.

began in late 1996, the ESOP had been in effect for two years. Profits had risen and resulted, based on a formula contained in the ESOP, in substantial bonuses for the top 600 executives in the firm. The ESOP agreement provided that arbitration would be used to determine the wage adjustment if the parties could not agree. The maximum amount the arbitrator could award, 5 percent per year, was also detailed in the ESOP agreement. The ALPA spokesman, however, stated that going into arbitration would signal a failure of the ESOP.

In December, a tentative agreement was reached at the bargaining table that called for a 3 percent increase for two years followed by 2 percent increase in the final two years of the agreement. The pilot's negotiating committee took this proposal to its Master Executive Council and eventually held a rank-and-file vote. The rank and file rejected the proposed agreement by a 4-to-1 margin. After the vote, the ALPA leader at United (who also served as its representative on the board) announced that the union and its members would no longer cooperate with management on any of the joint initiatives they had begun.

In the end, the parties returned to the bargaining table and reached an agreement. The settlement provided for 5 percent increases in the first two years of the contract and, perhaps more importantly, for employees' original wage levels—reduced as part of the ESOP plan—to be restored when the ESOP agreement expired in 2000. (This type of provision is often referred to as a "snapback" provision—wages snap back to their prior level.)

Passenger Service Agent Organizing Campaign

Another source of tension in the labor-management relationship emerged in 1997, when the IAM informed the company that it had signed authorization cards for a majority of the non-union passenger service agents and asked the company to recognize the union. The company felt it was in a dilemma, again caused by the failure of the parties to anticipate how to deal with such issues when they signed the ESOP agreement.

On the one hand, the company felt it would be inappropriate to actively campaign for the defeat of a union organizing drive. On the other hand, since these employees were not able to vote on the original ESOP plan, it seemed important to give them an opportunity to vote on this issue, rather than have the company decide on union representation for them. Moreover, within management, some executives wanted to present a factual statement about the question of these workers organizing. After failed attempts to negotiate an expedited process outside the election rules required by the National Mediation Board, an uncontested election was conducted. Management did hold information meetings, but with a few exceptions otherwise remained neutral. The majority voted for union representation, and the IAM was certified to represent these employees. In the end, the company's decision to require a vote created tensions within both the union and the board of directors.

Regional Jet Negotiations

After the ESOP plan was implemented, the company and ALPA returned to the difficult issue of how to structure an agreement to allow greater use of regional jets. The need to do so was intensified by the flexibility enjoyed by United's competitor, American Airlines. American maintains a separate company—American Eagle—to fly its regional routes. It had reached an agreement with its pilots in 1996 that gave it considerable flexibility in the use of this lower-cost alternative to feed its long-haul domestic and international flights. United's management and ALPA initially tried to address this issue in a problem-solving fashion that ultimately failed. In the end, they negotiated a very traditional agreement—14 pages of detailed rules governing the use of regional jets and the number of routes the regional carrier could fly.

Flight Attendants' Negotiations

In 1997, another significant negotiation occurred that once again demonstrated the mixture of traditional and innovative labor relations at United. The Flight Attendants Association (AFA) and the company negotiated a long-term (10-year) contract that involved considerable use of "interest based"—problem solving, joint analysis, and information sharing—techniques. The tentative agreement reached contained a "wage spike" that would increase wages above what appeared to be a competitive level at mid-term and then slowly bring the wage level back to around to what would likely be the industry standard by the end of the contract. The net result of this negotiation was to further chill relations with union leaders.

777 Rest Issue

In 1998, another issue arose that, when this paper was being written, was still being negotiated. It involved the company's plan to use 777 aircraft to fly its Pacific routes and the question of whether a bunk would be installed in these planes to provide rest time for pilots. Management indicated that Pacific routes were becoming more competitive, and the current 747s used to fly them needed to be replaced by more cost-effective 777s.

Again, an effort was made to introduce a more problem-solving approach to negotiations, but one that recognized the need to carry over certain traditional negotiating principles as well. Specifically, the company proposed a four-step process to guide these negotiations: (1) define the issue; (2) cost it in a reliable fashion and share the data; (3) define the implications of not reaching an agreement; and (4) set a strict deadline for getting an answer. This approach was designed in part to apply greater discipline in management's own approach to negotiations. (Many believed that, in the past, management felt the only power it had during negotiations was control over data and information—and so information was held closely.) The negotiations were also allowed to drag out without conclusive results. Management negotiators wanted the company to decide what it would do if an agreement couldn't be reached on this issue. When pressed, the answer was that, if no agreement was reached, United would stop flying its Pacific routes.

It took several months to generate the reliable cost data the parties needed to document the problem and negotiate the issue. Eventually, the company proposed that, while it could not outfit the 777s immediately with bunks, it would commit to do so by 2001; in the meantime, other rest accommodations were made for the pilots. The pilots responded with a counterproposal, and the company was drafting a response when this report was written.

This example illustrates how a blending of traditional and interest-based approaches to negotiations are being used at United. Within both the management and union organizations there is considerable opposition to and skepticism over moving too far in the direction of problem-solving approaches. Concern over a political backlash from the rank and file or potential rivals to current officers makes union leaders reluctant to appear to have a cooperative or cozy relationship with the company. The same views prevail among some company executives. These attitudes have been conditioned by the industry's longstanding tendency to wait until the amendable date to begin negotiations and to then take two years or more to negotiate an agreement. In an attempt to take a problem-solving approach, an early beginning was proposed for negotiations over the contracts that are amendable in 2000. However, there is considerable skepticism about this approach, particularly among IAM leaders. Thus, a mixed approach to negotiations is more likely to be followed to deal with the complex issues involved.

Leadership Succession

In September of 1998, United announced that its COO resigned from United after the board indicated he had lost the support of the unions and would not succeed Greenwald as CEO. Greenwald's term is up in 1999, and a search is now underway for his successor. Moreover, within the next two years there is likely to be a leadership transition within ALPA as well, since the union's rules allow only two consecutive terms for its leaders.

Renegotiation of Bargaining Agreements and the ESOP

The ESOP agreement expires in 2000, when the collective bargaining contracts reach their amendable date. As noted earlier, however, the governance features of the ESOP continue until 2019. Thus, the parties face critical choices regarding the leadership of the company, the process to use in renegotiating bargaining agreements, and the ultimate question of whether or not to renegotiate the financial terms of the ESOP—essentially, continuing it into the future or allowing it to slowly atrophy. At this point, ALPA appears to remain more interested in extending the ESOP into a second phase, while the IAM is less certain. While the top executives of the company continue to express support for the ESOP, views among other senior managers range from indifference to disinterest to a clear preference for allowing the ESOP to expire.

Taking Stock of the ESOP

What has been the ESOP's effect to date? While I have not attempted to conduct a systematic analysis of this question and more interviews of the different stakeholders involved need to be conducted, I can offer the following tentative observations.

The company has not improved its operating performance on the metrics commonly used in the industry to track quality and customer satisfaction. The most recent data published by the Department of Transportation (January through June, 1998) show that, out of the ten major U.S. airline companies, United ranks fifth in passengers declined boarding (i.e., those who are bumped due to over-booking), ninth in on-time performance, tenth in baggage mishandled, and sixth in consumer complaints.

While it has improved its profitability since 1994, so have its competitors in the industry. One effort to decompose the sources of increased profitability concluded that 90 percent of the increased profits are attributable to the following: (1) the labor cost reductions provided in the ESOP; (2) the tax benefits of the ESOP; (3) the increased demand for air travel experienced in the industry; and (4) savings and market growth associated with the regional jet/United Shuttle arrangements (Oakeshott 1997). The company's stock rose in tandem with the overall rise in the stock market from 1994 to 1997, increasing the value of the shares held by employees or cashed out by employees who left the company during this time period.

Yet, many executives within the firm believe that the investment community under-values the company's stock and cite the fact that it trades at only about nine times its earnings, compared to a multiple of 15 times earnings for its competitors. One industry expert agrees that the ESOP is not helping the company in the marketplace, especially given the uncertainties it faces with the anticipated departure of the CEO and uncertainty over his successor, the need to renegotiate the labor agreements, and the expiration of the ESOP plan in 2000. Thus, there does seem to be some price that employees and the firm are paying for the control employees exercise within the firm.

When asked if the ESOP has had a significant effect on the labor-management relationship within the company, one management official assessed it as essentially neutral—it has had neither a major positive nor a negative effect. The pilots and the company were, however, able to address competitiveness issues during the life of the contract, rather than stockpiling these issue until the scheduled renewal date.

Future Scenarios

Given this uncertainty, it is difficult to predict the future of the ESOP at United. One possible scenario is that the parties will allow the ESOP to expire in 2000, while the governance features continue well into the next century. How the investment community and the employees respond if this occurs is a topic open to debate.

A second scenario is that history will repeat itself—that is, the interest ALPA has in continuing the ESOP plan will lead it to propose a second-generation buy-out plan that maintains or perhaps even increases majority ownership by employees. To make this option successful, however, ALPA will again require the cooperation and support of other employee groups, particularly the employees represented by the IAM. What price the employees would need to pay to continue to be majority-owners is again an open question. Some within the ranks of management believe the price could be considerably higher than a one-for-one trade of wages for stock, especially since there is no clear evidence that the ESOP has enhanced performance and may lower the market value of the firm.

Other scenarios might identify ways to use the upcoming negotiations to better align the interests and outcomes of concern to the various stakeholders. Such an effort might involve, for example, some type of contingent performance and compensation arrangement whereby stock is exchanged if and when the company achieves specific performance targets. To negotiate this type of outcome would, however, require significant culture change and improvement in workplace relations and operations, and a more interest-based approach to negotiations.