

# CAN EMPLOYEE STOCK OWNERSHIP PLANS IMPROVE CORPORATE GOVERNANCE STANDARDS IN LATIN AMERICAN COUNTRIES?

*Ramiro Salvochea\**

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\* Adjunct Professor of Law, Universidad de Buenos Aires, Business School; Associate Professor of Law, Universidad de San Andrés, Business School; J.D., Pontificia Universidad Católica Argentina, Buenos Aires, 1996; Linkage Student, Yale University, School of Law, 2003; Master in Law, Universidad de Palermo, Buenos Aires, 2004; LL.M., University of Texas at Austin, School of Law, 2006.

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## I. FINANCIAL MARKETS IN THE WORLD

Berle and Means' book, published in the 1930's, depicted the modern corporation as one run by professional managers, potentially unaccountable to widely dispersed shareholders.<sup>1</sup> This structure was a product of the generation of big industries that dominated different economies by virtue of their economies of scale.<sup>2</sup> These big corporate monsters, managed by a handful of directors, generate large amounts of capital by carving out small units of equity claims.<sup>3</sup> The image of the modern corporation delineated by Berle and Means creates a widely dispersed ownership structure—an appearance seemingly inherent to the corporate system.<sup>4</sup>

Berle and Means' idea of the "modern corporation" has seen a lot of criticism.<sup>5</sup> In fact, studies show that widely dispersed share ownership is exceptional: Many countries presented an environment where firms typically had a dominant owner, whether it be a family group or the state.<sup>6</sup> Research by Rafael La Porta, Florencio Lopez de Silanes, and Andrei Shleifer has documented large differences among rich countries regarding the state of development of their financial markets, and has verified that many companies are controlled by small groups.<sup>7</sup> In effect, three distinct groups have been identified: (i) the common law countries (represented best by the U.S. and the UK) which have "market-centered economies"; (ii) the civil law countries, each with a few distinctions: the French (represented best by France and Italy) and German (clearly represented by Germany itself); and

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1. ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (Harcourt, Brace & World 1968) (1932).

2. Brian R. Cheffins, *Corporate Law and Ownership Structure: A Darwinian Link?*, 25 U. NEW S. WALES L. J. 346, 348 (2002).

3. See Henry Hansmann & Reiner Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J., 439 *passim* (2001).

4. BERLE & MEANS, *supra* note 1, at 47.

5. See Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 864-65 (2013); Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471, 471-72 (1999).

6. Gilson & Gordon, *supra* note 5, at 474, 491, 496.

7. Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3, 3-4, 8 (2000).

(iii) the Nordic countries, usually viewed as part of the “civil law” family, even though they have their own unique characteristics.<sup>8</sup>

Each of these groups presents corporate markets with different characteristics: Common law countries show dispersed ownership systems, characterized by strong financial markets, rigorous disclosure standards, and high market transparency.<sup>9</sup> French civil law countries usually have a strongly concentrated ownership system with controlling blockholders and weaker securities markets.<sup>10</sup> These countries witness high private benefits of control and low disclosure and market transparency standards. The German and Scandinavian countries are usually considered somewhere in the middle of the two paradigms.<sup>11</sup> Latin American countries are at the end of the line, presenting the most concentrated markets and allowing majority shareholders to grossly reap private benefits of control.

## II. DIFFERENCES AMONG COUNTRIES IN DEVELOPING FINANCIAL MARKETS

Due to the success of the economy in the United States, there appears to be a transition of some civil law countries towards the U.S. shareholder-orientated model.<sup>12</sup> But a worldwide discussion is taking place to explain the conditions necessary for a country to develop strong capital markets. The reasons for this dichotomy are not found in any singular answer. Empirical evidence appears to support the idea that a country’s governing law matters in developing liquid capital markets.<sup>13</sup> More specifically, the evidence shows that financial market depth and liquidity is closely correlated with the characteristics typical to each of the particular families of legal systems identified.<sup>14</sup> Among these systems, common law consistently outperforms civil law, as civil law usually provides inadequate protection to minority shareholders.<sup>15</sup>

The essential insight underlying this “law matters thesis” can be justified by the fact that in unregulated environments, there are real dangers that a public company’s “insiders” (comprised of controlling

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8. *Id.* at 8.

9. Gilson & Gordon, *supra* note 5, at 505.

10. Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1116, 1148 (1998).

11. *Id.* at 1116.

12. See Hansmann & Kraakman, *supra* note 3.

13. See *Investor Protection and Corporate Governance*, *supra* note 7, at 4.

14. *Id.*

15. Gilson & Gordon, *supra* note 5, at 505.

shareholders and senior executives) will cheat outside investors.<sup>16</sup> As an example, the U.S. legal system closely regulates the possibility of opportunistic conduct by insiders.<sup>17</sup> In the “law matters thesis,” minority shareholders will feel comfortable in countries like the United States.<sup>18</sup> As a result of such confidence in strong economies, investors will be willing to pay full value for shares made available for sale, effectively lowering the cost of capital for firms that choose to sell equity in financial markets.<sup>19</sup> The laws that exist may influence how capital is dispersed among stockholders.

In a country where the legal system offers little protection against cheating by insiders, the law matters thesis implies that the outcome must be different. Potential investors, fearing exploitation, will shy away from buying shares. Insiders, being aware of such skepticism, will decide not to sell equity to the public. They will opt instead to retain the private benefits of control and rely on different sources of finance even if they have to forego pursuing potentially profitable opportunities. The Berle-Means’ corporation will therefore not become dominant.<sup>20</sup>

Consistent with this view, some attribute the existence of concentrated ownership systems to a “rent-protection” model of shared ownership.<sup>21</sup> This model states that when private benefits of control are high, concentrated ownership will dominate over dispersed ownership.<sup>22</sup> Entrepreneurs taking a firm public will not sell a majority of the firm’s voting rights to dispersed shareholders in the public market because they can obtain a higher price from selling shares to an individual or small group who seek to enjoy both ownership and private benefits of control.<sup>23</sup> Thus, they will only sell either a minority interest, or control as a block.<sup>24</sup> In this same vein, others have also argued that when laws reduce transaction costs, a firm’s value increases.<sup>25</sup>

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16. Cheffins, *supra* note 2, at 349-50.

17. *Id.* at 350.

18. Hansmann & Kraakman, *supra* note 3, at 447.

19. Cheffins, *supra* note 2, at 350.

20. *Id.* (citing Bernard Black, *The Core Institutions that Support Strong Securities Markets*, 55 BUS. LAW. 1565 *passim* (2000); Peter Martin, *Keeping It All in the Family*, FIN. TIMES, May 4-5, 1996, at 1 (London)).

21. See Lucian Arye Bebchuk, *A Rent-Protection Theory of Corporate Ownership and Control* 1 (Nat’l Bureau of Econ. Research, Working Paper No. 7203, 1999).

22. *Id.* at 1.

23. John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 5 (2001).

24. *Id.* at 6.

25. Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 525-26 (2001).

Without the change in a nation's governing law, the disparity between ownership and control will remain. And yet, others have argued that the disparity has more to do with political and cultural conditions than do the laws in effect.

For example, John Coffee follows the theory that corporate behavior may be more shaped and determined by social norms than by legal rules.<sup>26</sup> His theory is based on the fact that the U.S. and U.K.—both current examples of dispersed and strong securities markets—did not have, in their origins, a consistent formal legal apparatus to protect minority investors.<sup>27</sup> This reality is arguably contrary to the “law matters thesis” and suggests that functional substitutes for close governmental regulation can be developed.<sup>28</sup>

Alexander Dyck and Luigi Zingales followed Coffee's theory and tested the effect of law and what they called “extra-legal institutions”—customs not far from the “social norms” stated by Coffee.<sup>29</sup> Although each is weighted differently, the “institutions” include the following: (i) product market competition; (ii) public opinion and pressure; (iii) internal policing through moral norms; (iv) labor as a monitor; and (v) government as a monitor through tax enforcement.<sup>30</sup>

Finally, Mark Roe offers a different, more “political” view.<sup>31</sup> In his theory, European social democracies pressure corporate managers to forego profit maximization opportunities to maintain high levels of employment.<sup>32</sup> As a consequence of these pressures, ownership concentrates as a defensive action.<sup>33</sup> He argues that block concentration gives large shareholders enough power to use hidden reserves, non-transparent accounting, and other mechanisms to better resist political pressures to expend the firm's resources on other constituencies.<sup>34</sup> Successful corporate governance systems in his theory cannot totally explain the reduction of managerial agency costs in all cases (although it is a precondition for a market with properly dispersed ownership) because it does not address the consequential costs of “mismanage-

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26. John C. Coffee, Jr., *Do Norms Matter? A Cross-Country Evaluation*, 149 U. PA. L. REV. 2151, 2152, 2190-91 (2001).

27. *See Rise of Dispersed Ownership*, *supra* note 23, at 81.

28. *See id.* at 60.

29. Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537, 539 (2004).

30. *Id.* at 576-78.

31. *See* Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539, 539 (2000).

32. *See id.*

33. *See id.*

34. *Rise of Dispersed Ownership*, *supra* note 23, at 51.

ment.”<sup>35</sup> Managerial agency costs are of two different classes: those arising from thievery or misappropriating corporate resources, and those related to other mismanagement.<sup>36</sup> Good law can clearly reduce the former but does very little to minimize the latter, as is the case of the U.S. corporate system. Indeed, Roe argues the *business judgment rule* has courts refusing to intervene when shareholders attack managerial mistakes.<sup>37</sup>

Roe further develops this argument by empirically testing his theory in several developed countries.<sup>38</sup> His results are consistent with his thesis. Particularly relevant for his argument is the case of Sweden, a country with well-developed stock markets on which many public firms trade, but also a country with strong legal protection for minority stockholders.<sup>39</sup> However, Sweden has also been a historically strong social democracy.<sup>40</sup> Thus, the schools of thought given by scholars can be grouped between those that accentuate the effect of an adequate legal protection, and those that stress the extra-legal elements.

### III. CULTURAL ELEMENTS AS A CAUSE OF THE UNDERDEVELOPMENT OF FINANCIAL MARKETS IN LATIN AMERICA

In a recent paper by Erica Gorga—while undertaking the social norms approach—she analyzes how culture can influence the legislative process.<sup>41</sup> She states that “introducing culture and ideology as a central feature—not as a residual variable—in the study of corporate outcomes can shed light on why nations have different patterns of corporate governance.”<sup>42</sup>

Gorga argues that culture potentiated rent-seeking interests in Brazil, thereby making adequate institutional changes in domestic cor-

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35. Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233, 236 (2002).

36. *Id.* at 235.

37. *Id.*

38. *Id.* at 233.

39. See Clas Bergström & Kristian Rydqvist, *Ownership of Equity in Dual-Class Firms*, 14 J. BANKING & FIN. 255, 257(1990) (analyzing the effectiveness of Sweden's corporate law by measuring voting premiums granted to minority stockholders).

40. *The Strange Death of Social-Democratic Sweden*, ECONOMIST, Sept. 18-24, 2010, at 16.

41. Érica Cristina Rocha Gorga, *Does Culture Matter for Corporate Governance? A Case Study of Brazil* 79 (Stanford Law Sch. John M. Olin Program in Law & Econ., Working Paper No. 257, 2003).

42. *Id.* at 54.

porate law impossible.<sup>43</sup> By using Brazil as an example, Gorga explains that culture and ideology contribute to the failure in creating an efficient corporate law system by playing a major role in shaping patterns of firm governance rather than just a residual influence.<sup>44</sup>

As Table 1 illustrates, empirical data clearly shows that financial markets in Latin America are very weak.<sup>45</sup>

Country	GDP per cap.(US\$) (1) (2002)	GDP per cap.(US\$) PPP adjusted (1) (2002)	Market Cap./GDP (2) (1997)	Total Value Traded/GDP P (2) (1997)	Claims of Deposit money banks on private sector/GDP (2) (1997)	Claims of other intermediarie s/GDP (2) (1997)	# of listed firms (3) (2002)	# of ADR (4) (2002)
Argentina	2400	-	0.11	0.04	0.15	0	152	24
Brazil	3580	7300	0.19	0.12	0.23	0.05	459	39
Chile	4590	9100	0.84	0.09	0.45	0.12	260	24
Colombia	2020	6060	0.13	0.01	0.16	0.15	74	3
Mexico	5070	8790	0.32	0.13	0.22	0.03	201	37
Peru	2080	4660	0.11	0.04	0.09	0.01	175	2
Average	3290	7182	0.28	0.07	0.22	0.06	220.2	21.5

(1) Country Risk Guide, Coface (2003).

(2) Dermigüç-Kunt, Asli and Ross Levine (2001), "Financial Structure and Economic Growth". MIT Press. (Data of 1997).

(3) ECONOMATICA.

(4) [www.NYSE.com](http://www.NYSE.com)

Many Latin American countries have scarce numbers of publicly-held corporations.<sup>46</sup> Yet, even when financial markets develop, there remains a very concentrated ownership pool that leads to problems of information asymmetry.<sup>47</sup>

43. Erica Gorga, *Culture and Corporate Law Reform: A Case Study of Brazil*, 27 U. PA. J. INT'L ECON. L. 803, 811 (2006).

44. *Id.* at 903.

45. ORG. FOR ECON. CO-OPERATION & DEV., WHITE PAPER ON CORPORATE GOVERNANCE IN LATIN AMERICA 53 (ORG. FOR ECON. CO-OPERATION & DEV. [OECD], WHITE PAPER ON CORPORATE GOVERNANCE IN LATIN AMERICA 53 tbl.1 (2003).

46. *Id.* at 48.

47. OECD, *supra* note 45, at 53 tbl.2.

Table 2  
Ownership Concentration

Country	Sample (2002)	% of largest shareholder (2002)	% of 3 largest shareholders (2002)	% of 5 largest shareholders (2002)
Argentina**	15	61%	82%	90%
Brasil*	459	51%	65%	67%
Chile*	260	55%	74%	80%
Colombia*	74	44%	65%	73%
Mexico**	27	52%	73%	81%
Peru*	175	57%	78%	82%
Average	168.3	53%	73%	79%

\* Data from ECONOMATICA.

\*\* Data from 20-F ADR filings.

The data shows that building a strong securities market in this region is impossible to do quickly and is hard to do *at all*.<sup>48</sup>

If we assume Gorga's argument to be true, and if cultural elements are key factors in explaining the failure to create an efficient corporate law system,<sup>49</sup> the question that must be answered is how to provoke the necessary cultural and ideological change.

#### A. *Latin America's Common Historical and Cultural Background*

Many Latin American countries have similar historical and cultural backgrounds. It would be a huge task to adequately analyze every country's background, and it certainly exceeds the limits of this work. Nevertheless, one must roughly analyze some common Latin American history to individualize the cultural elements that deter the development of a robust corporate environment.

In effect, almost every Latin American country was born out of a Spanish colony.<sup>50</sup> The Spanish colonial system was designed to reap the resources of each colony for the benefit of the colonial power.<sup>51</sup> As one historian noted, "The Spanish came in search of gold, not re-

48. Bernard S. Black, *Strengthening Brazil's Securities Markets* 1 (Stanford Law Sch. John M. Olin Program in Law & Econ., Working Paper No. 205, 2000).

49. *Culture and Corporate Law Reform*, *supra* note 43, at 903.

50. See RONALD M. SCHNEIDER, *LATIN AMERICAN POLITICAL HISTORY: PATTERNS AND PERSONALITIES* 37 (2007). *But see* Stuart B. Schwartz, *The Historiography of Early Modern Brazil*, in *THE OXFORD HANDBOOK OF LATIN AMERICAN HISTORY* 98 (Jose C. Moya ed., 2011) (The exception is Brazil which was colonized by Portugal, a county that had a very similar colonial policy to Spain).

51. See Schwartz, *supra* note 50, at 77.

ligious freedom.”<sup>52</sup> The shape each institution took after independence was certainly deeply marked by this well-known fact.

The Spanish divided the territory in several viceroyalties that were ruled in a very authoritarian manner.<sup>53</sup> The territory’s economy was closed to everyone but Spain.<sup>54</sup> Even with independence, democracy was uncertain to follow.<sup>55</sup> The leaders of the regional revolutions ruled like feudal lords, and the inhabitants remained devoted to rapidly exploiting the region’s economic offerings.<sup>56</sup> Even most of the Europeans who immigrated in the nineteenth century sought to make their fortunes and return home.<sup>57</sup>

This is perhaps why many Latin American countries experienced long military rulings during the twentieth century, not returning to democracy until very recently. In effect, Argentina welcomed democracy back in 1983;<sup>58</sup> Bolivia in 1982;<sup>59</sup> Brazil in 1989;<sup>60</sup> Chile in 1990;<sup>61</sup> Paraguay in 1999;<sup>62</sup> and Peru in 1980<sup>63</sup> Mexico did not suffer from military coups but had a fraudulently entrenched regime until 2000.<sup>64</sup> These political disturbances were accompanied by very deep economic crises, involving high inflation rates, government currency controls, and even freezes and expropriation of bank accounts and other private assets.<sup>65</sup> Mexican governments fluctuated from civilian to military rule, and from radical to conservative policies.<sup>66</sup> Such instability has certainly eroded the possibility of creating strong, dispersed financial markets.

52. DANIEL PONEMAN, ARGENTINA: DEMOCRACY ON TRIAL 8 (1987).

53. SCHNEIDER, *supra* note 50, at 57.

54. *See id.* at 69.

55. *See id.* at 76.

56. *See id.* at 77.

57. PONEMAN, *supra* note 52, at 8.

58. *See* Luis Alberto Romero, A History of Argentina in the Twentieth Century 255 (James P. Brennan trans., The Pa. State Univ. Press 2002) (1994).

59. *See* SCHNEIDER, *supra* note 50, at 476.

60. Adriano Nervo Codato, *Uma História Política da Transição Brasileira: Da Ditadura Militar à Democracia* [A Political History of the Brazilian Transition from Military Dictatorship to Democracy], 25 REV. SOCIOLOGIA 83, 83 (2005) (Braz.).

61. *See* SCHNEIDER, *supra* note 50, at 473.

62. *Id.* at 484.

63. MIRANDA LOUISE JASPER & CLARE RIBANDO SEELKE, CONG. RESEARCH SERV., RS22715, PERU: POLITICAL SITUATION, ECONOMIC CONDITIONS AND U.S. RELATIONS 2 (2008).

64. *See* SCHNEIDER, *supra* note 50, at 435.

65. *Id.* at 438.

66. *La Construcción de la Democracia en América Latina y Sus Desafíos Actuales* [The Construction of Democracy in Latin America and Current Challenges], REVISTA ESTUDIOS (Aug. 9, 2011) (Costa Rica), <http://www.estudiosgenerales.ucr.ac.cr/estudios/no24/papers/visec2.html>.

## B. Cultural Elements

The political history shows the elements that will be described in many Latin American countries that reflect *culture*. In my opinion, the following elements are more or less present in each of these developing countries, and each impacts the “concentration” of ownership, as well as the “weakness” of the securities markets:

*State Paternalism:* The *civil law* tradition—specifically from France and Spain—incorporates the idea of a very strong state that provides the needs to its citizenry.<sup>67</sup> Where an individual from a common law country “claims” in favor of his “natural” freedom to pursue personal success by using qualifications and effort as a tool to that end; an individual from a civil law country “claims” that the state owes him the right to earn enough to support himself, and a basic right to work (sometimes closely identified with his right to “a job”). The common law state will provide a rigid frame for individuals to develop their businesses while the civil law state will bend the rules to “correct” any inequality it perceives. This paternalistic civil law state acts through state-directed “redistribution.”<sup>68</sup> The existence of this phenomenon is supported when “recent research supports the proposition that civil law is associated with greater government intervention in economic activity and weaker protection of private property than common law.”<sup>69</sup>

*Entrenched Clientelism:* The paternalistic position the civil law state plays is the target of interest groups that try to obtain the “bending” of rules in their own favor. This easily generates corruption and an unproductive fight between different power constituencies. It is also a propend terrain for state expropriation of property rights.

*Normative Instability:* The Hispanic heritage of strong state involvement and pervasive political and economical instability during the twentieth century has generated the sporadic rotation of legal norms that change according to the particular group in power.

*Anticapitalism:* The role described in Section One assumed by the civil law state also generates a “populist” way of government. A natural consequence of this idea is the ideological conflict between the owners of productive resources and the lower sector of society.<sup>70</sup> While it is easy for employees, retirees, and people in general to identify the “shareholder” in the U.S., the same cannot be said for Latin

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67. *Law and Finance*, *supra* note 10, at 1116.

68. *See id.*

69. *Investor Protection and Corporate Governance*, *supra* note 7, at 12.

70. Gilson & Gordon, *supra* note 5, at 511.

American countries. This is due to the fragmentation of the securities markets and the relevance of small investor participation. Political discourse is often directed against the rich. This is true even when the disparity in the concentration of wealth tends to be much broader in developed countries.<sup>71</sup> Clearly, pursuing a concept like shareholder wealth maximization is very difficult in this context.

*Lack of a Culture of "Savings"*: Finally, citizens in many Latin American countries—due to historically high rates of inflation, arbitrary shifting of legal norms (e.g. taxes), and other reasons (e.g. the high rate of non-compliance of private pacts)—do not have a culture of “saving” because saving resources for future use could be futile if there is a relevant risk of expropriation.

#### IV. LABOR PARTICIPATION AS A FACTOR OF CHANGE FOR LATIN AMERICAN MARKETS

Labor participation has become one of the “hot spots” of modern corporate governance. While some argue that participation of labor in corporate governance has a negative effect on ownership structures, others defend the importance of creating a mechanism that protects the interests of company employees.<sup>72</sup>

Firms that are owned and controlled by employees have a number of efficiency disadvantages.<sup>73</sup> However, “these theories have generally focused on the problems that supposedly afflict worker cooperatives or firms with extensive employee control of management and boards of directors.”<sup>74</sup>

One of the earliest theoretical arguments against employee ownership came out of a model introduced by Benjamin Ward.<sup>75</sup> Rather than maximizing profits, Ward’s position argued that worker cooperatives would tend to maximize revenues per worker.<sup>76</sup> If the proceeds are to be divided among team members according to some fixed *ex*

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71. *See id.* at 511-12.

72. For differing perspectives on labor participation in corporate governance, see generally Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Jonathan Levin & Steven Tadelis, *Profit Sharing and the Role of Professional Partnerships*, 120 Q. J. ECON. 131 (2005); Alan D. Morrison & William J. Wilhelm Jr., 94 AM. ECON. REV. 1682 (2004).

73. Margaret M. Blair et al., *Employee Ownership: An Unstable Form or a Stabilizing Force?* 241 (Georgetown Univ. Law Ctr., Bus. Econ. & Regulatory Policy, Working Paper No. 142146, 2000).

74. *Id.*

75. Benjamin Ward, *The Firm in Illyria: Market Syndicalism*, 48 AM. ECON. REV. 566 (1958).

76. *See id.* at 571-72.

*ante* sharing rule, in any team production situation, each team member will have an incentive to shirk, as they would receive the benefits of shirking but would bear only a pro rata share of the cost.<sup>77</sup> Other authors argued that if employee ownership is viable at all, it is likely to be in low capital-intensity industries since employees as a class are generally not wealthy and are likely to be risk averse and liquidity constrained.<sup>78</sup>

One final argument against this form of employee ownership is based on the collective action problems that arise in any enterprise jointly owned by multiple individuals. Having too many owners may become an issue if they all have to agree on how the company should be governed, as each will have their own preference. Ownership rights should go to patrons with homogenous interests and those who will invest more capital into the company with the right to receive a pro rata share of the profits.<sup>79</sup>

Apart from worker cooperatives, firms with extensive employee control of management, or companies with boards of directors, many arguments have been directed to attack other forms of employee ownership, including the German “codetermination” model.<sup>80</sup> German codetermination, as an explicit manifestation of political social democracy, is said to have the effect of inducing firms to stay private to avoid shareholder costs in the form of employee input from inside the firm.<sup>81</sup> But social democracy without codetermination has the same effect. Managers want to avoid jeopardizing their careers: to that end, they will not engage in profit maximizing strategies if they are risky. Managers prefer to utilize existing capital rather than painfully restructuring the firm, and they would be more willing to tolerate slack than would shareholders.<sup>82</sup> Such managerial tendencies fit well with employees’ goals, creating a serious corporate governance problem: a tension between invested capital *viz-à-viz* current employees. As employees are also risk averse, they too prefer the firm to expand, pay higher wages, and have a lower level of productivity.

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77. See Alchian & Demsetz, *supra* note 72, at 786.

78. Blair et al., *supra* note 73, at 245.

79. *Id.* at 245-46.

80. Mark J. Roe, *German Codetermination and German Securities Markets*, 5 COLUM. J. EURO. L. 199, 199-200 (1999) (defining co-determination as a practice whereby the employees have a role in the management of a company).

81. MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT 33 (2003).

82. See *id.* at 34.

Social democratic governments wedged open the gap between shareholders and employees by creating laws and a social climate that made it harder for managers to downsize when technology demanded it, or harder for managers to take risks with the enterprise when markets warranted it from the shareholders' perspective.<sup>83</sup> The argument is convincing, and Roe gives supporting empirical evidence of this effect.

Nevertheless, labor participation in corporate governance has supporters. For many, all institutions essential to the basic structure of society must be consistent with the norms of moral equality and autonomy.<sup>84</sup> Consequently, "the principle of self-governance underlying political democracy extends to the economic sphere."<sup>85</sup> Since corporations are mechanisms of income allocation, by distributing resources to individuals that will use them to pursue various notions of good life, corporate structures are a part of the basic structure of society.<sup>86</sup> Value of employee ownership could be seen as primarily instrumental—ownership may foster independence and self-respect, encourage exercise of political rights, as well as a better economic understanding.<sup>87</sup> Finally, Aditi Bagchi describes the "utilitarian view," where employee ownership is viewed as an instrument for benefiting the general economy by promoting employee productivity and welfare.<sup>88</sup>

In addition to these instrumentalities, employee ownership can also be used as a tool of cultural change to defeat the negative paradigm inherent to Latin American countries, described above as a key factor in deterring the evolution of financial markets in this area of the world. In effect, labor participation would homogenize capital and working interests and help spread ownership among a more extensive portion of the population. Legislation often increases employee ownership for low wage workers.<sup>89</sup> It is therefore necessary to take certain legislative steps to implement this possibility. The type of such employee ownership may vary. Employees may control management,

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83. *Id.* at 36.

84. Aditi Bagchi, *Varieties of Employee Ownership: Some Unintended Consequences of Corporate Law and Labor Law*, 10 U. PA. J. BUS. & EMP. L. 305, 305 (2008).

85. *Id.*

86. See JOHN RAWLS, *A THEORY OF JUSTICE* 7 (rev. ed. 1999) (defining the basic structure of society—the primary subject of justice—as the distribution of fundamental rights and duties).

87. Bagchi, *supra* note 84, at 306.

88. *Id.*

89. *Id.* at 307.

share in the residual profits, or have the power to vest ownership in specific individuals or a group of employees.<sup>90</sup>

Employee ownership varies considerably across institutional environments. Bagchi compares the different developments in the United States, Germany, and Sweden, and discusses how legislation impacts the type of employee ownership structure that develops as a result of the changing law.<sup>91</sup> Nevertheless, by taking advantage of the freedom behind theoretical analysis, and by recognizing the problems surrounding the German model, it appears the United States' model would be the best system to implement in Latin America. More specifically, concentration should focus on the advantages in the Employee Stock Ownership Plans (ESOPs) governed by the United States' Employee Retirement Income Security Act (ERISA).<sup>92</sup>

## V. EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

An ESOP is a tax-qualified employee benefit plan that invests primarily in company stock on behalf of its employees.<sup>93</sup> Generally considered, there are various types of ESOPs. *Nonleveraged ESOPs*, like stock bonus plans, are used when the corporation pays for securities or stock rather than use commercial credit. One advantage to non-leveraged ESOPs is that the corporation can take an immediate tax deduction. When the corporation invests money into the corporation's trust, it essentially retains all the capital gained by the corporation.

There are also *Leveraged ESOPs*. Essentially, these ESOPs act as intermediaries in loan transactions. Rather than borrowing money directly, a company borrows it through a Leveraged ESOP. This occurs in the following manner: (1) a company first sets up a trust; (2) the trust then borrows money from a lender with the corporation guaranteeing to repay the loan; and (3) to repay the loan, the company makes tax-deductible contributions to the trust that the trust then gives to the lender. Although each loan must be used to acquire stock in the company, its proceeds can be used for any legitimate business purpose. As the debt is repaid, the stock is retired from the "suspense account" and allocated to the accounts of individual workers.

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90. *See id.*

91. *Id.*

92. Employment Retirement Income Security Act of 1974, 29 U.S.C. § 1051 (2012).

93. JOSEPH RAPHAEL BLASI, EMPLOYEE OWNERSHIP THROUGH ESOPs: IMPLICATIONS FOR THE PUBLIC CORPORATION 6-7 (1987).

Important to this article is the fact that the stock may be paid to the corporation's the employees upon retirement.

A similar version to a Leveraged ESOP is a *Company-Financed ESOP*. Here, the company borrows funds from the commercial lender, contributes amounts of stocks to the ESOP, and when the trust acquires the stock as it pays for the loan, it can change the amounts or frequency of its contribution.<sup>94</sup>

ESOPs have been the main engine driving the growth of employee ownership in the United States. In 1975, according to the National Center for Employee Ownership, 1,600 companies employing a total of 250,000 workers—0.25% of the labor force—had ESOP plans.<sup>95</sup> By 1995, more than 14,000 companies had broad-based employee ownership plans that covered roughly 14 million employees.<sup>96</sup>

Although ESOPs have been around since 1970, the term did not become common until after tax changes were implemented in 1985.<sup>97</sup> The most important incentives were incorporated in the Tax Reform Act of 1984,<sup>98</sup> which contained four important provisions that enhanced the attractiveness of ESOPs:

- (1) Shareholders of closely held corporations may sell some or all of their shares to an ESOP; if the ESOP owns more than 30 percent of the corporation, the shareholders may elect not to recognize any capital gain, providing that, among other conditions, the proceeds from the sale are invested in the stock, rights, and/or debt of another US corporation;
- (2) Banks making a loan to an ESOP for the purpose of acquiring employer securities can exclude 50 percent of the interest received on the loan from their gross taxable income, thereby making it cheaper for ESOPs to borrow money;
- (3) Corporations can deduct from their taxable income the cash dividends paid on stock held by an ESOP, provided that the dividends are paid out to plan participants within 90 days of the ESOP's year-end;

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94. *Id.* at 7.

95. SPECIAL PROJECTS UNIT, THE BUREAU OF NAT'L AFFAIRS, INC., *EMPLOYEE OWNERSHIP PLANS: HOW 8,000 AND 8,000,000 EMPLOYEES INVEST IN THEIR FUTURES 1* (1987).

96. *See id.*

97. Neil A. Wassner, *The ESOP Concept*, in *ESOPs IN THE 1980s*, at 7, 7 (M. Mark Lee & Robert M. Siper eds., 1985).

98. Tax Reform Act of 1984, Pub. L. No. 98-369, Div. A, 98 Stat. 494 (1984) (codified as amended in scattered sections of 26 U.S.C.).

(4) Under certain circumstances, an ESOP can assume all or part of a liability for estate taxes in exchange for employer securities obtained from the decedent or the executor.<sup>99</sup>

Having influenced the increase of ESOPs by encouraging the use of tax incentives, U.S. Economist Louis Kelso and U.S. Senator Russell Long are two of the most important men in ESOP history.<sup>100</sup> While Kelso believed strongly in capitalism, he knew that for more Americans to share in the economic prosperity, a broadened ownership of capital was needed.<sup>101</sup> After a meeting between the two, both came up with the idea of using pension plans as leverage to promote ESOPs. Employees would then have a greater incentive to be more productive because they owned shares of the company.<sup>102</sup> In 1986, roughly a quarter of the existing ESOPs owned more than 25% stock in their sponsoring corporation.<sup>103</sup> ESOPs are less common in large corporations that are publicly traded because the corporation does not own many outstanding shares of stocks.<sup>104</sup>

ESOPs are not the only forms of employee ownership utilized by U.S. corporations. Another very important form of employee ownership is the stock option plan, where employees are given the right to buy company shares for a specified period of time.<sup>105</sup> Although stock options have often been a form of executive compensation, they are increasingly offered to many or all of a company's employees.<sup>106</sup> 401(k) savings plans are another form of employee ownership. Especially in public companies, the employer may match the employee savings in the form of company stock, and employees frequently choose company stock as one of their investments.<sup>107</sup> Nevertheless, to date ESOPs remain the most powerful policy instrument for pursuing an increasing employee ownership in the U.S.

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99. M. Mark Lee & Robert M. Siper, *Introduction*, in *ESOPs IN THE 1980s*, *supra* note 97, at 5-6.

100. Wassner, *supra* note 97.

101. *Id.*

102. *Id.*

103. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO/PEMD-87-8, *EMPLOYEE STOCK OWNERSHIP PLANS: BENEFITS AND COSTS OF ESOP TAX INCENTIVES FOR BROADENING STOCK OWNERSHIP* 39 (1986).

104. SPECIAL PROJECTS UNIT, *supra* note 95, at 9.

105. Charles R. Smith & Richard E. Wood, *Stock Option Plans: Design, Accounting, and Securities Consideration for Executive Plans and Broad-Based Plans*, in *EMPLOYEE STOCK OWNERSHIP PLANS: A PRACTICAL GUIDE TO ESOPs AND OTHER BROAD OWNERSHIP PROGRAMS* 330 (Scott Rodrick & Corey Rosen eds., 1996).

106. *Id.* at 333.

107. Corey Rosen, *An Introduction to Employee Ownership*, in *EMPLOYEE STOCK OWNERSHIP PLANS*, *supra* note 103, at 24-25.

### A. *ESOPs Recognized Effects*

In the opening statement of Chairman Humphrey at a hearing of the Joint Economic Committee in 1975, he stated that ESOPs will increase economic growth for decades and prevent inflation.<sup>108</sup>

#### 1. Efficient Mechanism for Profit Participation

Employees are economically better off when they share in the company's profits rather than just receive wage increases.<sup>109</sup> As the company becomes more profitable, employees receive dividends and/or an increase in the value of company stock.<sup>110</sup> In effect, if employee stock ownership acts as a way of sharing the gains of competitive success independent of subsequent wage renegotiation, employees are then incentivized to remain with the company.<sup>111</sup>

In fact, according to a 1990 study performed by the National Center for Employee Ownership, "a typical employee in an ESOP can expect to receive a benefit equal to 1.5 times annual pay over ten years in the plan and four times annual pay after 20 years."<sup>112</sup>

#### 2. Powerful Incentives for Enhanced Productivity

Profit sharing also increases productivity by inducing changes in workers' attitudes toward the company.<sup>113</sup> Employees have a greater sense of responsibility to improve their work product and to ensure that co-workers also improve their productivity.<sup>114</sup> Employees' changes in productivity reflect the strengths and weaknesses of the company.<sup>115</sup> The following example is helpful:

Assume a \$1 per share increase in profits for a firm trading at price-earnings multiple of 10. All else equal, this will lead to a \$10 per share stock price increase, a much more vivid addition to employee wealth than corresponding distribution of cash. Stock ownership

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108. *Economic Stock Ownership Plans (ESOP's): Hearing on H.R. 69-174 Before the Joint Econ. Comm.*, 94th Cong. 2 (1975) (statement of Hon. Hubert H. Humphreys, Chairman, H.R. Joint Econ. Comm.).

109. Jeffrey N. Gordon, *Employee Stock Ownership in Economic Transitions: The Case of United Airlines*, in *COMPARATIVE CORPORATE GOVERNANCE* 387, 388 (K. J. Hopt et al. eds., 1998).

110. *Id.* at 414.

111. Derek C. Jones & Jeffrey Pliskin, *The Effects of Worker Participation, Employee Ownership and Profit Sharing on Economic Performance: A Partial Review* 4 (The Levy Econ. Research Inst. of Bard Coll., Working Paper No. 13, 1988).

112. Rosen, *supra* note 107, at 30.

113. *Id.*

114. Gordon, *supra* note 109, at 414.

115. *Id.*

also automatically locks in prior gains in a way that increases the employees' investment in the firm, which in turn enhances the incentive effects for subsequent periods. Paying out a profit-sharing bonus from year one keeps constant the employees' residual claim for year two. But in case of stock ownership, unless the employee sells off stock, the value of the residual claim will increase for year two. This gives the employee an economically more valuable ownership stake and the incentive to protect and enhance its value.<sup>116</sup>

The stock price also acts as a constant reminder of the common endeavor to successful gains. The effects of profit sharing are greater in companies with large incidences of human participation, where a high degree of employee cooperation may produce a competitive advantage.

### 3. Policy Mechanism for Broadening Ownership Participation

To provide a realistic opportunity for more U.S. citizens to become owners of capital, and to provide an expanded source of equity financing for corporations, it should be made national policy to pursue the goal of broadened capital ownership.<sup>117</sup>

Legislation to incentivize employee ownership is necessary to improve economic wealth within the United States. This was the explicit legislative intent in creating the ESOP plans and giving them the powerful tax incentives that boosted their utilization. Research shows that ESOPs have changed the amount and patterns of worker ownership in American society.<sup>118</sup> The estimated assets of ESOPs seem to be comparable to profit sharing plans. However, this is not the same as asserting they have significantly broadened wealth, as such an assertion has been disproven by several analyses.

There still remains some indication of a trend in the publicly-held firm toward employee ownership. Nevertheless, the existence of a positive trend toward employee ownership shows that it is a preference in some companies. At the end of the 1980s, over four-fifths of publicly-held companies had at least one defined contribution plan.<sup>119</sup> Blasi provides some statistical information showing that:

Various estimates indicate that 12 to 20 percent have deferred profit sharing plans, and studies suggest that plans with over \$10 million in assets tend to hold 34 percent of those assets in company stock. Nineteen percent of the Fortune 1000 firms have profit-sharing

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116. *Id.* at 415.

117. S. REP. NO. 94-690, at 17 (1976).

118. Blasi, *supra* note 93, at 13.

119. *Id.*

plans which hold 10 percent or more in company stock. About 50 to 70 percent of large manufacturing and nonmanufacturing firms have savings or thrift plans and 41 percent in one sample required investment in company stock. One in four publicly owned companies has a direct employee stock purchase plan, which includes most of their employees and involves no tax qualification. This figure is almost 35 percent for the Fortune 1000. But, over 90 percent of these plans hold less than 5 percent of the total corporate equity. . . . About 13 percent of the Fortune 1000 firms have no stock ownership plan of any kind.<sup>120</sup>

Participatory forms of organizing production bring equity, participation, and decentralization, and such reforms are not ruled out by the context of resource scarcity. This makes them ideologically friendly for social democracy environments like the ones reigning in Latin America. The ESOP policy, as it aligns closely to social democratic regimes, is also compatible with the "anticapitalist" position common in Latin American countries.

#### 4. Financial Tools for Raising Capital

As described, ESOPs permit sponsoring employers to borrow money through a trust and to obtain the ESOP's loan proceeds, repaying the ESOP loan at below-market rates. The proceeds can then be used to acquire new capital, repurchase shares, refinance debt, buy new operations, or be used in any other business purpose. With the proper tax incentives, this could provide a much needed pool of capital for the dead-thirsty Latin American markets.

#### 5. Solution to the Automatization of the Economy

It has been said that ESOPs will also provide a certain solution to the problem between increases in production technology and human labor.<sup>121</sup> This problem, of course, arises as technology permits production by mechanical means that require less participation of human labor.<sup>122</sup> Such technology would not be a threat to employee productivity if the employees are able to gain ownership in the company to make up for the decrease in productivity.<sup>123</sup>

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120. *Id.* (using data obtained by the author in conjunction with Hewitt Associates).

121. See Jones & Pliskin, *supra* note 111, at 22.

122. *Employee Stock Ownership Plans (ESOP's): Hearing Before the Joint Econ. Comm., 94th Cong. 145-146 (1975)* (statement of Louis O. Kelso, Managing Dir., Kelso Bangert & Co.).

123. *Id.* at 149.

## B. ESOPs Potential Cultural-Changing Effects

### 1. Defeating “Capital-Human” Cultural Enmity

By aligning the “capital and human” factors, ESOPs can become a vehicle of creating a culture of corporate investment. Indeed, if the goal is cultural change, employee stock ownership may offer advantages over other vehicles for economic participation like profit-sharing schemes. Stock ownership more credibly commits the firm to sharing in gains with employees than other forms of profit-sharing.<sup>124</sup>

Empirical studies have shown that employees react positively to being owners.<sup>125</sup> They clearly demonstrate that the more shares an employee owns, the more committed and satisfied they are to their company.

Labor participation would also open employees to the basic reality of business. Receiving input on commercial and financial problems that arise in managing a corporation will commit them to the general objective of achieving profits. With time, this can grow into a feeling of being part of a larger mechanism where owning a small share can make a significant difference.

In effect, financial sharing and worker participation in decision-making might have integral reinforcing effects on productivity.<sup>126</sup> In any case, there is no persuasive empirical data to prove this argument. Many studies have been made to determine the effect labor participation has on corporate productivity, but the conclusions are not definitive in any direction. This perhaps is the case because of the difficulties in measuring “performance.”

### 2. Union Weakening

There is no doubt that union representation has been one of the most important developments of the modern world. Nevertheless, too much power by unions—quite a common phenomenon in Latin America<sup>127</sup>—is an important baggage of the productive sector. Although this has never been an assurance against high unemployment rates, utilizing ESOPs can act as a mechanism to diminish the gigantic

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124. See BLASI, *supra* note 93, at 13.

125. See Rosen, *supra* note 107, at 30.

126. Felix R. Fitzroy & Kornelius Kraft, *Efficiency and Internal Organization: Works Councils in West German Firms*, 54 *ECONOMICA* 493, 495 (1987).

127. See Fernando Rios-Avila, *Unions and Economic Performance in Developing Countries: Case Studies from Latin America* 3, 7 (The Levy Econ. Research Inst. of Bard Coll., Working Paper No. 787, 2014).

“adversarial unionism”<sup>128</sup> that we find in Latin American cultures. In essence, the more costly labor collective bargaining in a determinate environment, the greater would be the incentive of employers to give ownership rights.<sup>129</sup> Unions, on the other hand, have historically been opposed to the introduction of ESOP policy.<sup>130</sup> In the midst of discussions about the ESOP legislation in 1975, railroad labor unions adopted a resolution after hearing a detailed presentation of the “Kelso Plan”; in connection with the provisions of the Regional Rail Reorganization Act, the unions rejecting the proposed ESOP in the resolution as “contrary to basic trade union principles and not in the best interest of railroad workers or the unions which represent them.”<sup>131</sup>

The alignment of capital-workers is not well received by unions because it changes incentives of the individual workers when facing their employer.<sup>132</sup> Due to the automatic readjustment of employee benefits in relation to varying performances, the unions’ role will be diminished. This, of course, does not mean that once ESOP legislation was introduced unions fought for its members to receive ownership benefits. John Curtis and Anna Jeans indicate that many heavily unionized industries have labor agreements protected by law in which management cannot unilaterally reduce labor costs.<sup>133</sup> This kind of employee ownership may be advantageous during times of significant economic change.<sup>134</sup> During such change, owning stock will relieve much of the financial distress experienced by its employees.<sup>135</sup> Owning equity will also alleviate the need to renegotiate employment contracts, as employees often do not have equal bargaining power in such circumstances.<sup>136</sup> Thus, companies are more likely to remain viable

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128. Hansmann & Kraakman, *supra* note 3, at 445 (explaining that adversarial unionism was used “as a means of dealing with problems of labor contracting and, in fact, began to disappear from the industrial scene.”).

129. Bagchi, *supra* note 84, at 312.

130. *See id.* at 321.

131. CONG. RESEARCH SERV., EMPLOYEE STOCK OWNERSHIP PLANS: CURRENT STATUS AND PROPOSED LEGISLATION 22 (1975), reprinted in *Employee Stock Ownership Plans (ESOP’s): Hearing Before the Joint Econ. Comm.*, 94th Cong. 9, 32 (1975).

132. *See* Blair et al., *supra* note 73, at 246-47.

133. John E. Curtis, Jr. & Anna Jeans, *The Financially Troubled Company: What About Its Qualified Employee Benefit Plans?*, 11 JOURNAL OF PENSION PLAN. & COMPLIANCE 121, 122 (1985).

134. Gordon, *supra* note 109, at 389-90.

135. *Id.* at 390.

136. *Id.*

when their employees are compensated with company equity rather than a fixed wage.<sup>137</sup>

### 3. Creating a Culture of Saving

The issuing of stock to employees is intended to create a strong commitment by way of a long-term investment in their benefit.<sup>138</sup> In effect, most plans lock the possibility of disposition of the stock by the employees, creating a monetary benefit deferred in time.<sup>139</sup> This mandatory saving will help create a culture of long-term thinking, which today is nonexistent in Latin American countries.

### 4. Incentive for Better Managerial Performance

Contrary to what happens in the German codetermination model where the labor participation is direct in managerial decisions,<sup>140</sup> ESOPs insulate management from labor force pressures to pursue short-term profits or to fatten current employee payouts at the expense of long-term value.

## VI. CONCLUSIONS

I fervently believe that the main reason why the legislative intent of boosting Latin American securities markets has failed is because of cultural and ideological problems. If this is true, results would be achieved only if we generate a deep and real change in the cultural paradigm. To that end, labor participation can be a magnificent tool. In due time, it has the ability to generate actual changes in the way of Latin American thinking.

Among the many forms of labor participation, the U.S. ESOP system presents very important advantages over others. ESOPs entail capturing residual earnings all the while avoiding labor tampering and distorting firm incentives.

ESOPs have demonstrated great value as an incentive for broadening ownership participation. They are also a powerful tool for raising capital that can be used for any legitimate business purpose. Empirical studies further prove that ESOPs act as a factor for increasing worker productivity.<sup>141</sup>

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137. *Id.*

138. *See id.* at 412.

139. *See id.* at 415.

140. *See* Hansmann & Kraakman, *supra* note 3, at 445.

141. *See* Jones & Pliskin, *supra* note 111, at 3-4.

But ESOPs can also have an impact on the negative cultural environment reigning in Latin American countries by helping to improve corporate market performance. Among these effects, aligning the “capital and human” factors can serve as a vehicle for both creating a culture of corporate investment and defeating a long-existent culture of “capital-labor” enmity. It can also help diminish the gigantic adversarial unionism that we find in Latin American culture. The collective bargaining conflict generates an enormous burden on local businesses that negatively impacts regional competition. ESOPs can also help to create a culture of saving, absent in the area due to the chronic political and economical instability, as well as the pervasive inflation that has reigned in Latin America during the twentieth century. Finally, ESOPs insulate management from labor force pressure to pursue short-term profits and to fatten current employee payouts at the expense of long-term value, thus improving internal corporate governance.

Empirical studies demonstrate that ESOPs have been a major success in the American environment for creating ownership dispersion and improving productivity.<sup>142</sup> And ESOPs—as mechanisms conceived for wealth distribution—can be easily digested by the ideological foundation of the legislatures and citizenry of the Latin American region. Its correct implementation, boosted by proper tax incentives, can start a change for better financial markets.<sup>143</sup>

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142. See Hansmann & Kraakman, *supra* note 3, at 452; *ESOP Statistics*, ESOP Ass’n, <http://www.esopassociation.org/explore/employee-ownership-news/resources-for-reporters#statistics> (last visited Mar. 11, 2015).

143. BERLE & MEANS, *supra* note 1.