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WORKFORCE TRUST IN LEVERAGED BUYOUTS

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ABSTRACT

Wealth transfer theory predicts that hostile takeovers such as leveraged buyouts (LBOs) abrogate contracts with the workforce, which in turn reduces trust in management. The alternative strategic entrepreneurship perspective implies that where firms are acquired to invest in growth opportunities for sustainable expansion, trust may be maintained, or even enhanced. Developing this argument, we propose an Innovation-Participation-Trust (IPT) model within which LBOs introduce operational innovation, which enhances workforce participation, thus increasing workforce trust in management. Empirical analysis of nationally representative matched data supports the model, thus suggesting that LBOs enhance the ability of firms to contract efficiently with the workforce.

INTRODUCTION

Trust is considered a valuable corporate asset that enhances the ability of firms to contract efficiently, facilitate implicit contracts to minimize opportunistic behavior, and encourage relationship-specific investment (Hill & Jones, 1992; Jensen & Meckling, 1976; Williamson, 1985). Reflecting this, an extensive literature has reported a positive relationship between trust in management and firm performance (Fulmer & Gelfand, 2012; Guiso, Sapienza, & Zingales, 2015).

However, an end of trust phenomenon, whereby corporations have broken past promises, and as a result are considered less sincere and honest by their workforce, has become a mainstay of popular business literature (e.g., Foroohar, 2016; Wartzman, 2017). Leading scholars have attributed this in part to financialization, with increasingly active financial markets and institutional investors requiring corporations to prioritize shareholder value, and thus renege on established agreements regarding workforce terms and conditions (Davis & Kim, 2015; Freeman, 2010; Kalleberg, 2012; Kochan, 2012; Stiglitz, 2015).

Leveraged buyouts (LBOs), within which private equity funds (PE) acquire the temporary ownership of firms using debt secured against the portfolio firm's assets and/or future cash flows, are often seen as particularly problematic in this regard. Wealth transfer theory argues that, unconstrained by promises from prior owners regarding workforce treatment, LBOs will implement organizational restructuring and changes to working practices that abrogate both

explicit and implicit contracts with the workforce to expropriate rents (Shleifer and Summers, 1988). This in turn will lead to reduced trust. Appelbaum and Batt (2014: 194) further suggest that “managerial complicity with breach of trust” is incentivized by LBO governance arrangements to address agency problems such as equity incentives for managers, debt bonding (which limits free cash flow), and a short-term focus (Jensen, 1993). Over time, this will limit the firm’s ability to contract *ex ante*, and discourage relationship-specific investments, with deleterious consequences for “valuable corporate cultures” and organizational performance (Shleifer & Summers, 1987: 7; Schnitzer, 1995).

Supporting the wealth transfer theory portrayal of LBOs as having harmful consequences for workforce trust in management (Shleifer & Summers, 1988), LBO case studies report reductions in workforce trust following buyouts (Appelbaum, Batt, & Clark, 2013; Boselie & Koene, 2010; Pendleton, Gospel, & Vitols, 2014; Rodrigues & Child, 2010). However, such case studies often draw on only limited numbers of interviews, and may be unrepresentative of LBOs overall (Brown & Medoff, 1988). Given this, several scholars have argued that greater understanding of the implications of LBOs for relational outcomes such as trust in management requires analyses based on large-scale nationally representative data (Appelbaum & Batt, 2012: 34; 2014: 194; Wood & Wright, 2010). Addressing this call, we create matched employer-employee data to provide the first nationally representative evaluation of workers’ perceived trust in management in LBOs relative to non-LBOs.

However, contrary to the wealth transfer theory portrayal of LBOs, we draw on the strategic entrepreneurship perspective (Wright, Hoskisson, & Busenitz, 2001; Wright, Hoskisson, Busenitz, & Dial, 2000), to propose that LBOs may have positive implications for trust in management. Developing an Innovation-Participation-Trust (IPT) model, we argue that rather than concentrating purely on efficiency savings, LBOs frequently seek to develop growth opportunities in improving portfolio firm performance. In doing so, they will implement operational innovation, which in turn will increase workforce participation in decision-making, thereby increasing trust in management. We find empirical support for the model, thus helping address the gap in theory and evidence on the “real” effects of LBOs and the “human side” of takeovers (Buono & Bowditch, 1989; Wright & Siegel, 2021).

LBOS AND TRUST: THE INNOVATION-PARTICIPATION-TRUST MODEL

The first stage of the IPT model concerns the relationship between LBOs and operational innovation. As outlined above, the strategic entrepreneurship perspective argues that where firms are acquired with a view to investing in growth opportunities for sustainable expansion (Holmstrom & Kaplan, 2001; Jensen, 1993), they will seek the development and more efficient utilization of human capital. Central to this will be the implementation of operational innovation (Bernstein & Sheen, 2016; Jensen, 1989) involving “modern management technologies” such as lean manufacturing, skills upgrading, performance-related incentives, and decentralized control (Bloom et al., 2015). The introduction of such operational innovation will be facilitated by: the injection of expertise from the PE firm’s executives who possess the knowledge, skills, and experience necessary to improve firm performance (Hoskisson et al., 2013; Matthews et al., 2009); injections of investment capital (Boucly et al., 2011; Wright et al., 2000, 2001); and a longer-term outlook than in stock market-listed firms constrained by quarterly financial reporting requirements.

Prior research exploring operational innovation in LBOs has identified upgrades to workforce skills, improved communication, delegated management, and the introduction of performance incentives following LBOs (Agrawal & Tambe, 2016; Bacon et al., 2008; Bernstein & Sheen, 2016; Bloom et al., 2015; Bruining et al., 2005. Siegel & Simons, 2010). Therefore, we hypothesize:

Hypothesis 1: Operational innovation occurs at a greater scale in LBOs than in non-LBOs.

The next stage of the IPT model argues that operational innovation in LBOs will result in higher levels of workforce participation in decision-making. For example, skills upgrades in LBOs (Agrawal and Tambe, 2016) might increase workers' job control (Jensen, Patel, & Messersmith, 2011); team-based work design might allow workers to exert influence over their work (Heller, Strauss, Wilpert, & Pusić, 1998: 15; Lawler, 1994); flattened organizational structures in LBOs might engender greater opportunities (and indeed the need) for workforce participation (Amess, Brown, Thompson, 2007; Siegel & Simons, 2010); and incentive pay systems might incentivize participation in decision-making. Although no prior research has explored the implications of operational innovation for workforce participation in LBOs, we hypothesize:

Hypothesis 2a: Workers report higher participative decision-making in LBOs than in non-LBOs.

Hypothesis 2b: The positive relationship between LBOs and workforce participation is mediated by operational innovation.

The final stage of the IPT model argues that high levels of workforce participation in LBOs will impact positively on trust in management. Although prior research has not explored this relationship specifically in LBOs, earlier studies nevertheless show that trust is higher where managers are responsive to workforce participation in decision-making (Glew, O'Leary-Kelly, Griffin, & Van Fleet, 1995; Heller et al., 1998; Kramer, 1999; Martin, Parsons, & Bennett, 1995; Whitener et al., 1998). Therefore, we hypothesize:

Hypothesis 3a: Workers' trust in managers is higher in LBOs than in non-LBOs.

Hypothesis 3b: The positive relationship between LBOs and workforce trust is mediated by employee participation.

Hypothesis 3c: The relationship between LBOs and workforce trust is explained by the serial mediation of a) operational innovation, and b) workforce participation.

Figure 1 about here

The IPT model is summarized in Figure 1. Model 1 concerns whether workforce participation is higher in LBOs than in non-LBOs, and whether this is mediated by operational innovation (Hypotheses 1, 2a, and 2b). Model 2 concerns whether workforce trust in management is higher in LBOs than in non-LBOs, and whether this is mediated by workforce

participation (Hypotheses 3a and 3b). Combining Models 1 and 2 then enables the serial mediation to be tested (Hypothesis 3c).

RESEARCH METHOD

Data and Sample

We draw on data from the Workplace Employment Relations Study (WERS) 2011 (the latest available) into which we merge unique variables on the buyout status of each workplace obtained from the Centre for Management Buyout Research (CMBOR). The WERS data are nationally representative of British workplaces with at least five employees within Standard Industrial Classification major groups D to O (agriculture, hunting, forestry and fishing, and mining and quarrying are excluded), once sampling weights are used. WERS comprises surveys of both workplaces and employees, with up to 25 employees being sampled in 2,170 of the workplaces in the management survey. The management survey response rate was 46 per cent, and the employee survey response rate was 54 per cent.

Because companies are not bought out randomly, we use coarsened exact matching to provide comparability between the LBO and non-LBO cohorts (Iacus, King, & Porro, 2011). This allows workplaces to be matched on their observable characteristics, including organizational size, workplace age, and Standard Industrial Classification major group. Our final sample consisted of 4,335 employees in 740 workplaces.

Measures

LBO Workplaces. 104 of the 740 workplaces are LBOs. At individual level, 623 employees are in LBOs, and 3,712 in non-LBOs.

Operational innovation. We use the following measures from the WERS management survey: ‘training breadth’; ‘team briefings’; ‘management communication channels’; and ‘quality circles’, and the following from the employee questionnaire (aggregated at workplace-level): ‘training depth’; and ‘individual incentive pay’. We dichotomize all the measures by calculating the median of each of the variables and converting all values above the median to 1, and those at or below the median to 0. We then combine the dichotomous measures into a single operational innovation measure (seven-point scale from 0-6).

Participative decision-making. Employee respondents were asked “Overall, how good would you say managers at this workplace are at: (i) seeking the views of employees or employee representatives; (ii) responding to suggestions from employees or employee representatives; (iii) allowing employees or employee representatives to influence final decisions” (all on a five-point scale from “very good” = 4 to “very poor” = 0), with responses combined into a single scale.

Trust. Using established items to measure trustworthiness of managerial behavior (Cook & Wall, 1980; Whitener et al., 1998), employee respondents are asked (i) “Managers here can be relied upon to keep their promises”; (ii) “Managers here are sincere in attempting to understand employees’ views”; and (iii) “Managers here deal with employees honestly”, with responses combined into a single scale.

Controls. Workplace level controls are: organizational size; Standard Industrial Classification major group; single independent workplace. Individual level controls are: pay;

employee age; the individual's Standard Occupational Classification major group; job tenure; part-time/full-time contract; ethnicity; gender.

Analyses and Model Estimation

We employ multilevel analyses (Koopman, Lanaj, Wang, Zhou & Shi, 2016, Veltrop, Bezemer, Nicholson & Pugliese, 2021), using a regression-based framework, which also allowed for the calculation of (cross-level) indirect effects based on 5,000 bootstrapped samples (Hayes, 2013).

RESULTS

We find the adoption of operational innovation is higher in LBOs than in non-LBOs ($\beta = 0.52, p < 0.05$). Hypothesis 1 is therefore supported.

Employees also report higher participative decision making in LBOs than in non-LBOs ($\beta = 0.31, p < 0.01$), supporting Hypothesis 2a. This relationship is partially mediated by operational innovation, with the indirect effect of LBO status on participative decision-making via operational innovation being $\beta = 0.05$ (0.52×0.09), and the bootstrapped 95% CI for the distribution of the product of the coefficients being $[.02, .09]$. Hypothesis 2b is therefore supported.

Turning to the direct effect of LBO status on trust, this relationship is positively significant ($\beta = 0.21, p < 0.05$), thus supporting Hypothesis 3a. In terms of whether this relationship is mediated by participative decision-making, the indirect effect of LBOs on trust via participative decision-making is $\beta = 0.20$ (0.31×0.64), while the direct effect is statistically insignificant, indicating full mediation. The 95% CI for the distribution of the product of the coefficients is $[0.11, 0.32]$, and the proportion of the total effect explained by mediation is 96%. Hypothesis 3b is therefore supported.

The coefficients for the integrated model testing H3c are given in Figure 1. The indirect effect of LBOs on trust via the serial mediation is $\beta = 0.03$ ($0.52 \times 0.09 \times 0.64$). The bootstrapped 95% CI for the product of the coefficients is $[0.015, 0.059]$. The total indirect effect is the effect of the serial mediation plus the effect of LBOs on trust via operational innovation only ($\beta = 0$), plus the effect of LBOs on trust via participative decision-making ($\beta = 0.17$, i.e. 0.27×0.64). This total indirect effect is therefore 0.20, which implies that 98% of the total effect (total indirect effect of 0.20 plus direct effect of 0.01) is explained by mediation. Moreover, serial mediation accounts for 15% of the total effect of LBOs on trust. Hypothesis 3c is therefore supported.

DISCUSSION AND CONCLUSION

Extending the strategic entrepreneurship perspective of LBOs, we develop the IPT model, which posits that LBOs increase operational innovation, thus increasing employee participation in decision-making, in turn increasing employee trust in management. Offering the first quantitative exploration of the implications of LBOs for workforce trust in management, we find empirical support for the model.

Our findings thus call into question the wealth transfer theory argument that LBOs abrogate contracts with the workforce in order to transfer wealth to the new owners, causing trust

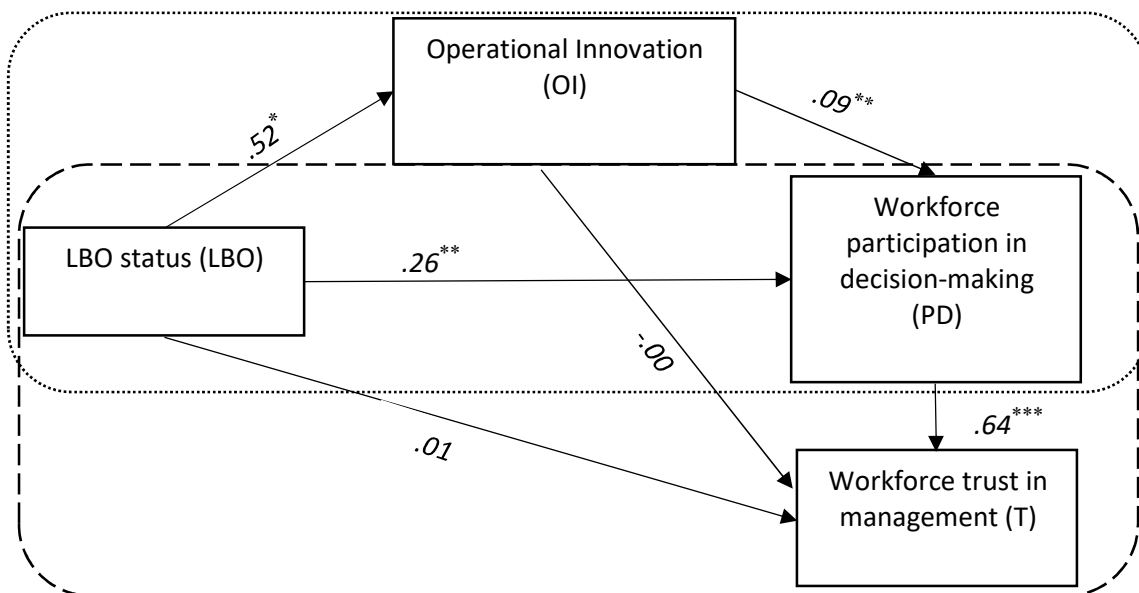
in management to decline (Appelbaum & Batt, 2014; Shleifer & Summers, 1987). Our findings also suggest that case studies showing reduced trust in LBOs (Appelbaum et al., 2013; Boselie & Koene, 2010; Pendleton et al., 2014; Rodrigues & Child, 2010) may be unrepresentative of LBOs overall. This is important given LBO critics' arguments that breaches of trust in hostile takeovers may justify additional anti-takeover protections. Our analysis suggests such protections are unnecessary on these grounds.

Instead, our findings are consistent with the strategic entrepreneurship perspective (Wright et al., 2000, 2001) that LBOs make significant investments in operational innovation to improve efficiency and for long-term growth (Agrawal & Tambe, 2016; Bernstein & Sheen, 2016; Bloom et al., 2015; Holmstrom & Kaplan, 2001; Hoskisson et al., 2013; Jensen, 1993; Lichtenberg & Siegel, 1990). Our findings also question the depiction of LBOs as a short-term ownership form. Although investments in operational innovation may take considerable time to yield returns, we find such innovation is more widespread in LBOs than in non-LBOs.

We therefore conclude that LBOs enhance the ability of firms to contract efficiently with workers, and thereby develop relationship-specific capital for *ex ante* value creation. Future studies might explore whether operational innovation in other types of (non-LBO) takeovers increases workforce participation and trust in management. In addition, studies exploring the implications of LBOs for the workforce might look beyond trust to consider the implications of operational innovation for other outcomes including job quality and human capital development.

REFERENCES AVAILABLE FROM THE AUTHORS

Figure 1: IPT model of the relationship between LBOs, operational innovation, workforce participation in decision-making, and workforce trust in management



..... **Model 1** The effect of LBO status on PD, mediated by operational innovation

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