Y 4
Sm 1/2
B 96/2/
979-2

96th Congress
1st Session

COMMITTEE PRINT

GOVERNMENT
Storage

THE ROLE OF THE FEDERAL GOVERNMENT AND EMPLOYEE OWNERSHIP OF BUSINESS

SELECT COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

REVISED MARCH 20, 1979

Printed for the use of the Select Committee on Small Business

---

U.S. GOVERNMENT PRINTING OFFICE
42-129 O WASHINGTON : 1979

AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

979-37

SELECT COMMITTEE ON SMALL BUSINESS

GAYLORD NELSON, Wisconsin, *Chairman*

SAM NUNN, Georgia
JOHN C. CULVER, Iowa
WALTER D. HUDDLESTON, Kentucky
DALE BUMPERS, Arkansas
ROBERT MORGAN, North Carolina
JAMES R. SASSER, Tennessee
DONALD W. STEWART, Alabama
MAX BAUCUS, Montana
CARL LEVIN, Michigan

LOWELL P. WEICKER, JR., Connecticut
BOB PACKWOOD, Oregon
ORRIN G. HATCH, Utah
S. I. HAYAKAWA, California
HARRISON H. SCHMITT, New Mexico
RUDY BOSCHWITZ, Minnesota
LARRY PRESSLER, South Dakota

WILLIAM B. CHERKASKY, *Executive Director*
COREY M. ROSEN, *Professional Staff Member*
ROBERT J. DOTCHIN, *Minority Staff Director*

SUMMARY

In the last several years, there has been a growing trend for employees to own substantial equity in the companies for which they work. It has been estimated that there are between 1,000 and 3,000 employee stock ownership plans ("ESOPs") in the country, and in at least 90 cases, employees, through ESOPs or other means, have actually purchased a majority interest in their companies. In part, the popularity of ESOPs has been a result of special tax incentives enacted in the last five years; in part it stems from the belief on the part of many companies that ESOPs provide a unique means of financing growth and providing an employee benefit plan with the same dollars. Similarly, the trend towards employee acquisition of business has partly been encouraged by government loans, 13 of which have been made to date. On the other hand, roughly 70 percent of the employee owned companies have been formed in this decade, so government assistance had usually not been a factor. This report will review the information available on employee ownership of business, with particular emphasis on the role the government has played and might play in the future.

Employee ownership has been sold primarily as a means to increase worker motivation and productivity by giving employees a clearer stake in their companies. A comprehensive study by the University of Michigan's Survey Research Center has confirmed that this argument is valid. In a study of 98 firms, the study found that companies with employee ownership were 1.5 times as profitable as comparable conventional firms. They also found that employee and managerial satisfaction was higher, and that managers reported increased productivity. Other studies of the plywood industry and individual case studies have confirmed these findings, and the plywood studies showed, in addition, that wages were 25 percent higher in employee owned firms than non-employee owned firms. The higher wages were compensated for by 30 percent greater productivity in the worker owned companies. Finally, the Michigan study showed that the greater the amount of equity owned by employees, the greater the profits.

The most popular form of employee ownership is the employee stock ownership plan. In its typical form, a company establishes an ESOP and the ESOP includes an employee stock ownership trust. The trust secures a loan for company growth, with the company pledging to make whatever funds are necessary available to the ESOT to repay the loan. The ESOT uses the loan funds to purchase company stock, so that the company gets the money from the loan and the trust gets the stock. As the loan is repaid, the stock vests with employees. Contributions to the trust to repay the loan are tax deductible, so that the company can, in effect, deduct both the principal and interest on the loan, instead of the interest only. In addition to this tax benefit, companies making qualified investments can receive an additional 1 percent–1.5 percent credit if the investment is financed through an ESOP.

The benefits and disadvantages of ESOPs have been widely disputed. For the company, there are, in some cases, cheaper ways to borrow, and the issuance of new stock to an ESOT dilutes the value of existing stock. The employee, although he pays nothing for the ESOP (unless there is a contribution plan), may be asked by the company to rely on the ESOP as his employee benefit plan in lieu of something else. If the company succeeds, this will be to his benefit; if it fails, the benefit is worthless. For companies with good prospects without access to other sources of equity capital, however, ESOPs appear to be very useful for financing growth as well as being very beneficial for individual employees. Moreover, the ability to deduct both principal and interest payments on loans makes ESOPs uniquely suited to employee purchases of companies. There is no other means by which this could be accomplished as well in these situations. Finally, ESOPs offer special tax advantages to owners of nonpublic companies who wish to transfer ownership of their companies, either gradually or through an immediate sale, to their employees.

While ESOPs have gained in popularity as a tool for existing companies, employee purchases of companies have gained in popularity in cases where companies would otherwise close. In the last decade, perhaps 50 or 60 such purchases have occurred. In most cases, an ESOP is used, but a variety of other ownership forms, including producer cooperatives and simple direct purchases of companies through the sale of stock to employees and others, have also been used. The motivation for such purchases is generally to preserve jobs that would otherwise be lost when a company plans to close, relocate, or be purchased by an unrelated interest. Roughly 70 percent of the employee purchases since 1971, in fact, have been of conglomerate subsidiaries which were scheduled to close. Most of the rest appear to have been voluntary sales by owners of independent businesses to their employees when the owners were ready to retire. The companies that have been purchased in this way appear to have been very successful, in many cases transforming companies or subsidiaries with poor performance records into profitmakers. Despite their success, however, efforts by employees to purchase their businesses still face enormous obstacles in the areas of financing and simply organizing people around what is still an unconventional goal.

Government policy toward employee ownership has been mixed. On the one hand, the Congress has enacted special tax benefits for ESOPs, and the Small Business Administration, the Economic Development Administration and the Farmers Home Administration have all made loans to employee organizations which have purchased their businesses. The ESOP tax incentives, however, are limited primarily to capital intensive, large companies. Certain so-called incentives for ESOPs, in fact, actually only have the effect of equalizing the treatment of ESOPs with other employee benefit plans. Government loans have been made, but not frequently—SBA has made three, EDA nine, and FmHA only one. The SBA has expressed reluctance to make loans to employee organizations and will not make loans to companies or employee organizations through ESOPs, arguing that the employee stock ownership trust is not formally a small business and therefore does not qualify for a loan. EDA has made more loans, but their legislative mandate is such that they must give priority to companies suf-

fering from the effects of disasters, defense realignments, or government regulations. FmHA officials have expressed enthusiasm for the idea of employee ownership, but their loan program has not been seen, as yet, as a potential source of funding. Even if it were more broadly known that FmHA were favorable, however, only companies in places of less than 25,000 people would be eligible, and even then small business would be encouraged to go to SBA.

In the 95th Congress, a bill was introduced by Congressmen Kostmayer, Lundine and McHugh to create a special program in EDA, with $100 million in loan funds for employee or employee/community organizations seeking to purchase firms that would otherwise close, relocate, or be sold to outside interests. Loans would be granted only if feasibility studies confirmed that the company could make a profit when reorganized. The bill was not acted on, however, and will be reintroduced in the 96th Congress.

In the Senate, Senators Nelson and Long will introduce legislation to mandate that the SBA guarantee loans to ESOTs on a non-discriminatory basis, and that SBA guarantee loans to employee organizations seeking to purchase their businesses when they would otherwise close, relocate, or be sold to unrelated interests. These loans would also be granted on the basis of feasibility studies, without regard to the individual assets of employees, a criterion that, if in effect, would make it all but impossible for employee organizations to secure credit, Senator Nelson also plans to introduce legislation similar to the House bill mentioned above.

Given the lack of enthusiasm and regulatory policy of SBA and the legal limitations on EDA, legislation such as that proposed by Nelson, Long, Kostmayer, Lundine and McHugh is necessary if the government is to take a more active role in encouraging employee ownership. The alternative to this policy would be to allow the businesses to close and to make the variety of transfer payments that are involved when there is extended unemployment, such as occurs when a plant closes. Given the success of employee ownership, it seems much the wiser course for the government to make or guarantee loans, the large majority of which would almost certainly be repaid, then to spend money on various programs designed to ease the impact of unemployment. Of course, such loans should only be made to companies with reasonable prospects for success, and the government should not strive to make loans in every instance. Government encouragement of the concept and practice of employee ownership, however, could convince at least some conventional credit sources to treat it as just another way of organizing a business. That, it appears, would be a very positive development which could significantly increase the productivity, wealth, and job satisfaction of employees, as well as preserve and improve local businesses. Finally, it would accomplish these things within the framework of free enterprise rather than government regulation.

CONTENTS

	Page
Summary	III
Introduction	1
I. Dimensions of employee ownership	2
II. Employee stock ownership plans	4
III. Non-ESOP modes of ownership	10
IV. Transfer of ownership to employees	14
V. Government support for employee ownership	16
VI. Evaluating employee ownership	18
VII. Case studies	19
VIII. Legislation	22
Conclusion	24

THE ROLE OF THE FEDERAL GOVERNMENT AND EMPLOYEE OWNERSHIP OF BUSINESS

Introduction

In the last several years, there has been a growing trend for employees to own substantial equity in the companies for which they work. In a large number of cases, employees have actually purchased their firms. In some instances, employee ownership has been encouraged by government tax benefits or by direct or guaranteed loans, but in others it has been the result of purely private initiatives. Whatever the causes of the trend towards employee ownership may be, however, the results appear to be very positive: A broader distribution of equity and participation in the capitalist system, the preservation of businesses and jobs that would otherwise have been lost, greater profits, and higher levels of productivity, wages, and worker and management job satisfaction.

Problems have been encountered as well, of course, particularly in the area of transition to new management forms and preventing employee owned companies from being sold to other interests, but the apparent success of the experiment suggests that it merits serious attention by the government. If employee ownership as a concept is successful it could help provide a means of preventing unemployment, broadening economic opportunity, and increasing productivity. This report will evaluate employee ownership of business and the role the government currently plays in encouraging or discouraging it.

According to various estimates, there are approximately 1,000–3,000 employee stock ownership plans (ESOPs) in the United States, the vast majority of which provide employees with a minority of stock in a company. In addition, there are at least ninety companies in which a majority of the assets are owned by employees (both management and hourly—companies owned only by management employees are not considered in this figure). These companies range in size from several employees to several thousand. A list of the companies is included in the appendix. As the list shows, the companies are widely distributed around the country and represent a broad range of industries. 80 percent of these firms were formed since 1971 and 57 percent since 1975, and roughly 70 percent were the result of a corporate divestiture.[1] As later sections will make clear, these companies have been very successful. They have higher profits, wages, and productivity levels than comparable firms.

Two main arguments support the idea of employee ownership. One is that it would make possible a broader distribution of wealth in the United States.[2]

---

[1] From data gathered for a forthcoming study by Donna Sockell of Cornell University.

[2] For a detailed discussion of this issue and possible remedies, including employee ownership, see "Broadening the Ownership of New Capital: ESOPs and Other Alternatives," a staff study for the Joint Economic Committee, U.S. Congress, June 17, 1976.

42-129 O - 79 - 2

In 1972, for instance, 6 percent of the people in this country held 49.5 percent of all assets, including 72.2 percent of all stock, and had 52.4 percent of the total net worth.[3] A broader distribution of wealth, it is argued, would increase not only the material well-being of people, but also would give them a greater sense of participation in the economic system. This in turn would result in greater productivity.

The second argument is that employee ownership provides a means to save businesses and jobs when a company would otherwise close, be liquidated, or relocate, possibly abroad. Many companies close for reasons unrelated to profitability, such as the retirement of the owner or cash needs of a conglomerate; while others which were previously unprofitable can be made profitable when employees actually own the company. Employee ownership, in these cases, would provide a very desirable alternative to a program of government transfer payments for unemployed workers. This, of course, would also be a tremendous benefit to the community which would otherwise lose the business activity and have to be a contributor to the unemployed.

The Government policy on employee ownership has been mixed. The Small Business Administration, the Farmers Home Administration, and especially the Economic Development Administration have made loans to employee organizations who have purchased their firms, but the number of loans has been limited (13) and most employee takeovers have had to be accomplished through conventional financing means. At this point, financing employee ownership conventionally is extremely difficult. Government tax support for employee ownership has concentrated on ESOPs, giving substantial benefits to companies who can take advantage of these provisions.

The remainder of this report will develop these points in detail, with particular attention to companies actually owned by employees, as it is in this area that Congress will be considering new legislation next year.

I. Dimensions of Employee Ownership

As mentioned above, according to one estimate approximately 1,000–3,000 firms have ESOPs.[4] ESOPs are employee ownership plans in which employer contributions and/or the use of employee stock ownership trusts as leveraging devices are used to transfer stock ownership to employees over a period of time. Their operation will be discussed in detail below. There are, in addition, an undetermined, but probably small, number of companies whose assets are directly owned by employees, either through stock purchase or cooperative purchase of assets.

Roughly ninety firms have been identified in which a majority of the equity is owned by a majority of the employees. This list probably is fairly comprehensive for all but the smallest of businesses, since it excludes what is probably a large number of small producer cooperatives.

The characteristics of employee owned firms recently have been explored by the University of Michigan's Survey Research Center.

---

[3] James D. Smith and Steven Franklin, "The Distribution of Wealth Among Individuals and Families," 1975.

[4] Employee Ownership: Report to the Economic Development Administration. Survey Research Center. Institute for Social Research, University of Michigan. estimated 1,100 in 1977, while the Employee Stock Ownership Council of America estimated 3,000 to committee staff in 1978.

In a survey of 100 employee owned firms, the Center found that 68 of 98 firms for which data was available were owned through ESOPs.[5] In a related study, about one-third of the firms were found to be small, using the Small Business Administration's criteria.[6] The ESOP firms tended to be larger than the non-ESOP firms.[7] Table 1 gives a detailed breakdown of the size characteristics of the surveyed firms.

TABLE 1.—SIZE CHARACTERISTICS OF EMPLOYEE OWNED FIRMS BY OWNERSHIP TYPE

[In percent]

	ESOP's (68)	Direct (30)	Total (98)
Number of employees:			
4 to 99	18	20	18
100 to 249	18	37	23
250 to 999	38	23	34
1,000 plus	26	20	25

Source: "Employee Ownership, op. cit."

The percentage of equity owned by employees varies considerably as well:

TABLE 2.—PERCENT OF EQUITY OWNED BY EMPLOYEES, BY EMPLOYEE TYPE, AND BY OWNERSHIP PLAN

[Percent owned by/ all workers/percent owned by hourly workers]

	Ownership plan					
	ESOP's		Direct		Total	
	All	Hourly	All	Hourly	All	Hourly
Percent of equity owned:						
0 to 9.9	4	50	4	16	4	40
10 to 49.9	18	43	18	20	18	36
50 to 100	78	7	78	64	78	24

Source: "Employee Ownership, op. cit."

The table shows that employees own a majority of the equity in a majority of the companies. This is probably misleading, however, if it is taken to be representative of all companies with some degree of employee ownership. The 100 companies identified for the survey are probably owned by employees more than the several hundred not identified, since the survey was not a random sampling, but simply a survey of all the companies the authors could find that were known to have employee ownership. Those with substantial employee ownership, being unusual, are probably better known and thus more likely to be included. Committee staff, for instance, has been able to find only 90 companies in the country in which a majority of the equity is owned by a majority of employees. It appears, therefore, that in most companies with employee ownership allow employees to own only a minority of the stock, and that the distribution of ownership is skewed towards management.

The table is more revealing with respect to the differences between direct and ESOP ownership. In directly owned companies, hourly workers are much more likely to own a majority of the equity (64 per-

[5] Employee Ownership, op. cit., p. 7.
[6] Sockell, op. cit.
[7] Employee Ownership, op. cit.

cent of the cases), whereas in ESOP companies hourly workers own considerably less (only 7 percent of the ESOP companies have hourly employees owning a majority of the equity). These companies concentrate ownership in managers, since most distribute stock according to salary to qualify for certain tax benefits. Overall, the study found that regardless of ownership form, firms of moderate size (100–250 workers) were most likely to be owned by hourly workers.[8]

The study found that companies chose to become partly or wholly owned by employees for a variety of reasons, but ESOP firms cited employee incentives most commonly, closely followed by the financial benefits to the firm of using ESOPs for capital acquisition. Directly owned companies cited saving jobs most frequently.[9] The reason for this is that ESOPs are generally set up by existing companies as employee benefit plans, while direct employee ownership is usually the result of employee efforts to keep a plant alive.

In the following sections, ESOP and direct ownership plans will be evaluated in greater detail. The overall performance of employee owned firms will then be evaluated, followed by a section on government support for the idea and one on pending legislation.

II. Employee Stock Ownership Plans

Employee Stock Ownership Plans are largely the effort of Louis Kelso, a San Francisco attorney who has argued that the success of the capitalist system will depend on broadening stock ownership. When a company sets up an ESOP it can now qualify for a number of tax benefits, a result of Congress's favorable position on the plans. Partly as a result of these benefits, ESOPs have been spreading widely in recent years.

Under an ESOP, a company establishes an employee stock ownership trust (ESOT). As Congress specified in the Employee Retirement Income Security Act of 1974, the trust, if properly established, qualifies as a stock bonus plan under section 401(a) of the Internal Revenue Code. The Trust then arranges a loan from a bank or other credit source to be used for company capital needs. The creditors will require that the company fully guarantee the ESOT borrowing, something the company is specifically allowed to do under the 1974 Pension Reform Act. The Trust uses the money it has received from the creditor to purchase company stock. The stock stays in the Trust; the company pledges to pay the Trust sufficient amounts to repay the principal and interest on the loan. Interest and principal are tax deductible, up to 15 percent of the covered payroll or 25 percent if the plan is being used as a retirement fund. The company benefits in that normally only interest payments are deductible on a loan. The entire contribution to the ESOT is thus in pretax dollars, so that a company in a 46-percent bracket will, in effect, be paying only 54 percent of the cost of both the program and the loan. The employees benefit because they will acquire the stock, which will vest with them as the loan is repaid. Vesting usually begins a few years after the loan is made. The employees receive their stock when they retire, died, or leave the company.

---

[8] *Employee Ownership, op. cit.*, pp. 14–5.
[9] *Employee Ownership, op. cit.*

Ten year income averaging, rollover into Independent Retirement Accounts, and capital gains treatment of the income, are the usual ways to avoid paying high taxes on the benefits. During their period of employment, however, the employees have paid nothing for the stock.

This added stake in the company, theoretically, will help the morale and motivation of the employees, resulting in greater productivity. The distribution of stock is usually made according to salary.[10] Plan participation is voluntary.

This description of ESOPs suggests that they allow a company to use the same dollars to repay a loan and to establish an employee benefit plan, while deducting much of the cost through tax writeoffs. As we shall see below, moreover, ESOPs have additional special tax benefits. There is, however, considerable disagreement about the actual benefits of ESOPs both for the company and for the worker.

ESOPS AND TAXES

The Tax Reduction Act of 1975 established an additional 1-percent investment tax credit for any company setting up a qualified ESOP. The essential new qualifications were that the stock had to be distributed accordingt o salary (ignoring amounts over $100,000), stock voting rights had to be passed through, and vesting had to be immediate. Until that time, ESOPs had been limited primarily to small, closely held companies which have used ESOPs as a means of creating a market for their stock, transferring ownership of stock to favored employees, or establishing an employee benefit plan. Use for financing growth was less common.[11] The 1-percent credit meant, however, that a company which was making investments, qualified under the investment credit provisions of the law, could receive from the government an amount equal to 1 percent of the cost of the investment if they established an ESOP. In other words, the government would make a contribution to the ESOP. The 1975 Act applied only to 1975 and 1976. In 1976, however, it was extended to 1980 and increased to 1.5 percent, provided the employees contributed .5 percent (otherwise the 1-percent credit applied). In 1978, the credit was further extended to 1983.

ESOPs established under this act (called TRASOPs) have been found primarily in large, capital intensive industries, for it is these companies who are making large enough investments and have few enough employees so that the 1- or 1.5-percent credit amounts to a significant amount per employee.[12] By contrast, for a large retailer, for instance, the benefit per employee would be less than $10.[13] Under these conditions, the cost of establishing the plan would exceed its benefits, especially since the plan requires that employees have voting rights. Even if a company had an ESOP, it might choose not to use the credit if it were small or labor intensive, due to the additional plan requirements stipulated by the act. Finally, a company cannot be sure that the credit will last beyond 1983, even though the ESOP obligation established under the bill would continue past that date.

---

[10] *Employee Ownership, op. cit.*
[11] *ESOPs—An Analytical Report,* Hewitt Associates, 1977, p. 12.
[12] Broadening the Ownership of New Capital, op. cit., pp. 41–9.
[13] *Making New Capitalists—A Creative Response to Income Inequities,* Richard J. Smith, Department of State Executive Seminars, 1978, p. 18.

In addition to the limits of the tax advantage under the Tax Reduction Act, there is some debate over the usefulness of ESOPs to finance growth and employee benefit funds with pretax dollars. A company could borrow money from a creditor and make a stock contribution equal to the principal amount of the loan to an employee fund. The tax situation of the company would be precisely the same, since it could deduct the interest on the loan and the amount being contributed in stock to the fund.[14] While the difference between the two approaches would be negligible for the employer, except that he would not have to create an ESOT, the employee might notice a very important difference: under an ESOP, the entire amount of the loan is credited to the ESOT at the time the loan is made (in stock). In the alternative plan, stock accumulates only as the loan is repaid. The employee thus loses all the appreciation on the stock not credited to the fund over the life of the loan, an appreciation which could be substantial, especially during periods of inflation. Viewed conversely, if the employee must wait for installments of stock over a period of years, he is, in effect, having the value of the stock discounted by its anticipated appreciation, including the amount due to inflation.

In sum, the tax benefits for a company employing an ESOP are significant for some companies, but for most the tax laws simply put ESOPs on a similar footing with other employee benefit plans. The increase in their use, therefore, probably cannot be attributed to tax incentives per se. In fact, as of 1978, only 200 TRASOPs had been set up, but, altogether, there were at least five times as many ESOPs.[15] The spread of ESOPs, therefore, must be attributed to its other uses: a vehicle for financing, a genuine desire of employers to broaden stock ownership as a means to increase employee incentives, or as a means to transfer ownership of a company to employees. Data referred to above confirm this view. The following sections will explore these areas in greater specificity.

ESOP'S AS A FINANCING VEHICLE

The primary advantages of ESOPs as financing vehicles were listed at the outset of this chapter: The entire loan repayment (principal and interest) is deductible, there is a tax credit for some companies of 1 or 1.5 percent, a source is provided for buying out large stockholders or transferring stock to employees, and ESOP financing can be used simultaneously for a wide variety of financial needs and setting up an employee benefit plan with the same dollars. These advantages must be set against a number of disadvantages:

(1) A company could follow the example set forth on the preceding page and contribute stock to a fund as it repaid the loan. This would be less beneficial for employees, but the company would retain the stock, and thus any appreciation it might have, for a longer time.

(2) The issuance of new stock to the ESOT will mean a dilution of stock value for existing shareholders unless the new growth financed through the ESOP is large enough to offset the dilution. This can be of serious concern in a small, privately held company, especially if the plan carries voting rights with it.

---

[14] *Making New Capitalists*, op. cit., p. 19.
[15] *Making New Capitalists*, op. cit., p. 20.

(3) ESOPs must confrom to pension laws and, if a credit is sought, TRASOP provisions. The cost of compliance may be a significant barrier for some companies.[15a]

Of course, in any case, a company seeking to finance new growth must evaluate all the costs of whatever financing method it chooses—debt financing (eg; conventional loans), equity financing (eg; selling stock), or ESOP financing. One careful analysis of the costs of these approaches was made by Hewitt Associates. The study assumed that the company was in the highest tax bracket and thus could make full use of the principal and interest deduction features of ESOP, but did not assume the 1 percent credit was claimed. The study concluded that ESOP financing was better than debt financing by 15 percent over a 10-year period, but 15–20 percent worse than equity financing.[16] Of course, this example makes a number of important assumptions, but it does suggest that ESOPs should be more popular with closely held companies, since they would have difficulty with equity financing. Other than publicly held companies using the 1.5 percent credit of TRASOPs, this does seem to be true among ESOP companies.

The study also may be less applicable to small firms with lower corporate tax rates. For them, the ability to deduct the principal and interest portions of the payments to the Trust are less important than for more highly taxed firms.

As with the tax benefits for ESOPs, then, the financing benefits appear mixed and appropriate only to certain firms. A large or moderate sized company with a payroll large enough so that the borrowing it envisaged would be less than the 15 percent limit on deductibility would be ideally suited for ESOPs.

The previous two sections, however, have disaggregated the benefits of ESOPs and evaluated them separately. In fact, the primary advantage of an ESOP is that it can simultanelously be used for financing, for tax benefits in some cases, and for establishing an employee benefit plan, a plan which, by disbursing ownership, should increase motivation. While a company might be able to accomplish all these goals separately for the same money, ESOPs provide a convenient device to do all three which, at least for some companies, could provide important financial benefits.

ESOPs should not be evaluated only as a tool for the company, however, since they have important consequences for employees as well, as will be discussed below.

USING ESOP'S TO TRANSFER OWNERSHIP TO EMPLOYEES

Before turning to the effects of ESOPs on employees, however, one additional function of the plans needs to be considered their use to transfer a business to its employees. It is in this respect that ESOPs are particularly helpful. All analysts, including those critical of ESOPs, seem to agree that they provide a very advantageous approach for these situations.

There are two situations in which a company is sold—a divestiture from a parent company or a sale from an independent owner upon retirement, death, movement to a new position, etc.

[15a] For a comprehensive review of ESOP financing disadvantages see Jared Kaplan, "ESOP's Fable." *Taxes*, 1975, pp. 898–912.

[16] ESOP's—An Analytical Report, Hewitt Associates, 1977, pp. 34–5.

In the divestiture case, an ESOP would work as follows: The parent company creates a new company, which in turn creates an ESOP. The ESOP sets up an ESOT which secures a loan, which the new company (and sometimes the parent company) guarantees, using the assets of the company it is about to buy as collateral. The ESOT uses the money from the loan to buy the new company. The assets of the new company are exchanged for stock in the company (in effect, the ESOT gives the assets to the new company in return for an equivalent value in stock). The loan is repaid through the ESOT by the new company, which has pledged to make sufficient funds available to the ESOT for repayment. The payments through the ESOT, of course, are deductible up to the 15-percent or 25-percent limit.[17]

The company could accomplish the same thing by getting a bank loan and then setting up an employee benefit fund and making stock contributions equal to principal payments. This would amount to the same thing as an ESOP, except that the employees, who are now the owners of the company, would not get the full benefit of stock appreciation as the loan is being repaid. Since the employees now own the company, there would be no reason not to set up a plan in this manner.

Unless a government agency or the parent firm is backing up the loan to the ESOP, it is unlikely that a bank or other creditor would loan the money for the purchase of the company unless the individual employees could put forward a substantial amount of their own capital. The ESOP device, therefore, is not a magical tool for creating capital and credit where none existed before, but it is extremely useful in many circumstances.

The main benefit it offers is the creation of a market for the subsidiary. When a parent company decides to close or sell a subsidiary, other buyers may be reluctant to take the firm over. In many cases, the buyers simply may be other conglomerates only. ESOPs thus offer a way to sell a company so that new company is an independent, locally owned firm. Because the ESOP offers a means for purchasing the company in pretax dollars the new buyers are off to a better start than if they had to raise their capital on their own to buy the firm (in that case only the interest would be deductible). The result of all this is that the parent company has a buyer and the employees, rather than losing their jobs or being taken over by another conglomerate, can keep their jobs and have a stake in their new company.

ESOPs are also very useful when an owner wants to sell his company or his share in his company. Normally the sale of stock by an owner to his corporation is taxed as income, unless all or most of the stock is sold at one time, which an owner may not want to do as he plans to leave a company over a period of time. Under an ESOP, the owner simply makes contributions to an ESOT (straight contributions, not new borrowings), which the ESOT then uses to buy the stock. The IRS has held that this is not the same as a normal stock purchase and the sale of the stock is treated as a capital gain.[18]

In addition, of course, in any sale by an owner to his employees, the ESOP offers the same advantages as in the divestiture case: Creation of a market and the ability of employees to buy the company in pretax dollars.

---

[17] "ESOP: Pluses and Minuses", Robert Reum and Sherry Milliken Reum, *Taxes*, July–August, 1976, p. 139.

[18] Neil Wassner, statement before the Joint Economic Committee, hearings on ESOPs, 1975.

Unlike the other aspects of ESOPs, then, their use in transferring ownership seems almost unequivocally beneficial, especially for the employee purchasers. Only in the case where a company desires to sell to another company through an exchange of stock (which would avoid capital gains taxes) would an ESOP purchase present a problem. This option only applies, however, in cases where a subsidiary is highly marketable and another conglomerate with desirable stock is interested.

ESOPS AND EMPLOYEES

ESOPs are clearly beneficial to employees seeking to buy their firms, but in ongoing concerns their benefits depend on the values of the employees.

ESOP proponents claim that ESOPs provide employees with stock at no cost to them. Thus, even if the company goes out of business and the stock becomes worthless, the employees have not lost anything. This, however, is an unrealistic view, since the ESOPs are likely to be viewed by the company as a form of employee compensation, thus reducing the need for other modes of compensation.

For the employee, in many cases, the choice is between an ESOP and some other form of employee benefit plan, such as profit sharing or, in some cases, a pension plan. Ownership of stock in the company is only beneficial, of course, inasmuch as the value of the stock increases. If the stock increases at rate faster than the loan rate, then the employees benefit more than had the money simply been returned through profitsharing.[19] If the stock declines, the employees lose, and if the plan represents their pension, they could face serious problems. Since most firms do eventually close, this is a problem that must be addressed.[20] In California, ESOP insurance at reasonable rates has started.[21] Employees can also be assured of gaining some equity when the company is sold or liquidated.

On the other hand, data will show later that employee owned firms do much better than non-employee owned firms, and the more equity employees own, the better the companies do. If a company succeeds, an employee, over the life of his participation, could accumulate considerable sums. ESOP proponents point to workers who have left ESOPs with hundreds of thousands of dollars. Finally, participation in ESOPs is voluntary, and employees could bargain for a choice of employees—ESOPs or a like contribution to another benefit plan.

Unions have generally opposed ESOPs due to the risks involved and due to a fear that worker-owners will be co-opted by management.[22] Where ESOPs are an employee benefit program, clearly the employees have the most to lose in relation to other alternatives. Employees must choose whether participation in their companies' possbile success or failure is worth more than a more secure and conventional plan. The decision is not unlike deciding whether or not to buy stock or put money in the bank, except that the employee knows the stock better and can contribute to its value.

Where ESOPs are used to purchase or eventually transfer ownership to employees, however, the situation may be viewed differently.

---

[19] *Broadening the Ownership of Capital, op. cit.*, p. 37, and *ESOP's: An Analytical Report, op. cit.*, pp. 24–5.
[20] *Broadening the Ownership of Caiptal, op. cit.*, p. 36.
[21] Statement of Louis Kelso before JEC hearings, *op. cit.*
[22] *Broadening the Ownership of New Capital*, op. cit., p. 38.

42-129 O - 79 - 3

Now the employees must choose between a simple wage and an opportunity to earn a wage and partake substantially in the company's direction and future. The risks are greater, but, since individual employees are not liable if a company does go bankrupt or suffer losses except inasmuch as salaries may decline, the risks are not as great as normal ownership. All of the psychic and financial opportunities are present, however.

These psychic rewards, of course, are one reason why ESOPs are established. Management hopes that employees will be stimulated to greater levels of productivity. Their hopes seem to be confirmed by the studies available (cited below in section VI), although it appears that ESOPs which provide only small amounts of stock to employees have little impact. Employee ownership of substantial equity, on the other hand, provides considerable incentives.

In sum, ESOPs present both risks and advantages for employers and employees, and each case must be evaluated individually. Nonetheless, ESOPs appear very useful for transferring ownership to employees and, in ongoing businesses, can often create substantial opportunities for businesses and employees. While not the financial miracle some proponents claim, they have important advantages, perhaps the most significant of which is the possibility for a new way of organizing American worklife by creating a much broader participation in the capitalist system.

III. Non-ESOP Modes of Ownership

While ESOPs have gained considerable popularity and constitute the bulk of employee ownership plans, there are alternatives to ESOPs. The most common of these alternatives are cooperative ownership, in which all or most employees purchase shares of a company and participate in its management, and direct ownership, in which employees purchase all or part of a company but retain traditional mangement forms. Both forms have advantages and disadvantages, but both require that individual employees put up a substantial amount of their own capital in order to purchase their companies, a process that requires not only considerable willingness to undertake risk on the part of employees, but also requires tremendous organization and leadership in order to assure that the employees will actually put forth the necessary capital in the limited time available to purchase the firm. While this obviously presents significant obstacles, using this procedure may make lenders and the company's prior owners more wiling to loan or sell than in an ESOP situation, where employees may not be risking any of their own assets.

COOPERATIVE OWNERSHIP

There are an unknown number of producer cooperatives in the United States, most of them small, non-conventional local businesses often motivated by concerns other than profit. While these businesses present an interesting alternative to traditional business forms, they will not be discussed in this report, which is, instead, focusing on uses of employee ownership in the more traditional sphere of business organized primarily for profit. The reader interested in these businesses

is referred to Daniel Zwerdling's excellent collection, *Democracy at Work.*[23]

Cooperatives have been used to organize more traditional businesses in at least a few industries, and case histories are available for those in agriculture, garbage collection, and plywood manufacturing. Of these, the most detailed information is available on plywood coops, and they present an important and illustrative example of the potential and problems of cooperative organization.

In the Pacific Northwest, there are currently about 16 cooperative plywood companies, about half the number that have been created at one time or another in the last 50 years. Most are of moderate size, and collectively they account for about one-eighth of the total Douglas Fir Plywod output.[24] The first of the cooperatives was formed in 1921 in the Seattle area, which had a large Scandinavian population with a cooperative tradition.[25] The company's success led to the formation of other plywood coops, sometimes at the instigation of promoters who took advantage of the workers.

The coops provided that each member would be allowed to buy only one share. In many companies, this could be done through a payroll deduction plan. Every shareholder is guaranteed a job. Wages are the same for all shareholders, but all the companies have non-owner general managers who are paid substantially more. Also, many companies hire non-owning workers, especially for temporary or less-desirable jobs, and most companies have incentive pay systems for unpleasant work. Shareholders elect a board of directors from among their ranks, and the directors meet periodically to make policy decisions. Day to day management is in the hands of the general manager. Directors, of course, continue at their jobs, and most usually serve for a limited time. Working shareholders are paid conventional wages, but at the end of the year are returned "surpluses" (the coop word for profits). Share values generally increase, and now are worth from $20,000 to $200,000.[26]

The subsequent resale of stock by retiring workers is limited to people who will or could become workers in the company (although it is not necessary to take a job immediately). Dividends are very limited so that benefits of ownership will accrue primarily to worker-owners. Shareholders can demand a job at any time when they are not working.[27]

Overall, the plywood coops have been successful. Some have made a great deal of money for their owners, while others have just survived and still others have failed. Given the often difficult conditions in the industry over the period of their existence, however, the companies have an admirable performance record. Workers, in addition to the share value they have accumulated, are paid about 25 percent more than in comparable plywood companies and are about 30 percent more productive.[28] Interestingly, Northwest plywood unions are uncomfor-

---

[23] Daniel Zwerdling, *Democracy at Work* (Association for Self-Management, Washington, D.C., 1978).

[24] Bruce Stokes, "Worker Participation and the Quality of Worklife", (Worldwatch Institute, Washington, D.C., 1978), p. 28.

[25] Carl J. Bellas, *Industrial Democracy and the Worker Owned Firm,* (New York, Praeger Publishers, 1972), p. 17.

[26] For an excellent review of the plywood coops and their structure see Katrina Berman, *Worker Owned Plywood Companies* (Pullman, Washington State University Press, 1967).

[27] Berman, *op. cit.*

[28] Paul Bernstein, "Run Your Own Business", *Working Papers for a New Society,* v. 2, No. 2, summer, 1974.

table with the coops, since the role of the union is less important in the coops (most do have unions, but they are mostly concerned with relatively minor matters) and since coops will reduce worker pay when the company is not doing well.[29]

Management of the coops can present problems, since the workers are always tempted to reduce investment for the future in order to increase wages or surplus returns in the present. When financial problems arise, raising new capital becomes difficult, since it cannot be raised through stock-offerings and some creditors have been reluctant to make loans.[30] Nonetheless, most of the plywood coops have managed to overcome these problems.

In fact, of the plywood companies that have gone out of business, four did so because they were too successful. Share values increased so much that no new investors could be found who were willing to buy the shares. Those with enough money would not be interested in working in the company, with the result that in order to dispose of the shares and to raise new capital the companies were forced to sell to larger firms. Of course, in addition, the shareholders made substantial profits through the sale and generally urged that the sale be made.[31] Some other plywood coops only lasted a short time, as they were the creation of promoters trying to unload a dying business or simply to get rich quick by taking a substantial fee for their efforts.[32] According to Bernstein, only four of the coops simply failed once they had been established.[33]

One way to solve the problem of shares costing too much to attract new worker-owners would be for all companies to use a payroll deduction plan. Another approach would be to limit share value to a certain amount for the worker and have the company purchase the excess value, contributing the excess amount (a percentage of the actual share value) to a pension fund which would be recapturable by the employee only when he left the company.[34] The problem, although difficult, is capable of resolution, provided the coop plans ahead.

Coops do present one significant tax benefit to owners in that the IRS has ruled payments to shareholders could not be considered taxable corporate income, allowing the owners to transfer profits to themselves at lower tax rates than would be the case if they were retained as company profits. IRS rules require, however, that the coops show that the wages they pay are not in excess of reasonable labor costs. Since the coop workers have been more productive than their non-coop counterparts, the IRS has allowed the coops to pay substantially higher compensation to their employees.[35]

In sum, the coop experience in the plywood industry has been generally successful, demonstrating that workers can own their companies and manage them as well, and in so doing make high wages and a company "profit" (which they can keep for themselves). Although growth and management problems do arise, the problems have not been insurmountable. The rewards for the workers—a secure, high paying job in their own company—have been, it seems, well worth the efforts

---

[29] Berman, *op. cit.*, p. 127.
[30] Bellas, *op. cit.*, p. 97.
[31] Bernstein, *op. cit.*
[32] Berman, *op. cit.*
[33] Bernstein, *op. cit.*
[34] Bernstein, *op. cit.*
[35] Berman,, *op. cit.*, pp. 165 and 175.

to overcome obstacles. It appears, however, that few other cooperative ventures exist, and none are so widespread or well-developed as the plywood coops. Detailed information about them is not available. The most that can be said, then, is that the coop alternative shows considerable promise, but has been too uncommon to justify any firm conclusions about the precise role it might play in American business.

DIRECT WORKER OWNERSHIP OF BUSINESS

The phenomenon of workers buying their companies directly is a relatively recent one in this country. In this situation, when a company would otherwise close or relocate, workers, sometimes in cooperation with local community people, agree to raise the money needed to buy the firm themselves, generally through a purchase of stock issued by the new company. Of all forms of worker ownership, this is the most simple and direct as far as transition arrangements are concerned. It is not, however, easy to accomplish.

From the data gathered by the Survey Research Center and by committee staff, it appears that about one-fourth of the the employee owned firms (where employees own half the equity or more) are owned directly by employees or employee-community groups. The term direct ownership here is simply meant to distinguish between firms in which ownership is accomplished through an ESOP or through a cooperative and firms in which employees or employees and local people simply purchase the stock of a company on a normal stock offering basis (although stock may be limited to employees or local people, and ownership of more than a certain amount of shares may be prohibited). Unlike coops, owners can own more than one share.

The direct ownership concept is surely the simplest of the three arrangements discussed. When a plant is about to close, an organization is formed to sell stock in a new company which will buy the old plant from its previous owner. Generally, it appears that the stock offering is not limited to employees in order to facilitate raising the necessary capital, although some companies limit subsequent resale to the company or to employees. In some cases, the sale has been from former owners who have gradually transferred stock to employees over a period of time, while the company continued in operation, while in a few cases, employers have simply given the stock to their employees (most notably in International Group Plans of Washington, D.C.).

When a benevolent owner does not exist, raising the necessary capital in this manner can be extremely difficult. Employees may be asked to raise thousands of dollars in a few days or a few weeks. Banks may be very unwilling to loan money at this point, given the uncertainty of the endeavor at this early stage. Employees may end up owning worthless stock. Nonetheless, since their jobs are at stake, the investment risk may seem worthwhile. From the information available to the committee, it does not appear that any employees have lost their investments in the cases that follow this pattern that have occurred in this decade, when most of the employee takeovers have taken place.

Once the stock is owned by the company, and operating loans are secured, the company has a number of options concerning the role employees will play as owners. From the cases on which information is available, however, a common pattern seems to have emerged: Employees vote their stock, as would any owner, but the board of directors

rarely has substantial employee representation and worker participation in management is generally limited. The employees, in buying the company, are naturally primarily concerned with preserving their jobs, and give little thought to how the company will be run once it is saved. Moreover, it appears most companies do not plan for the transfer of stock from retiring employees to new employees, so that the idea of employee ownership may fade over time. Some companies do not even provide that stock must be sold back to the company, so that an outside interest can purchase a majority of company stock. This is precisely what happened in one of the best known cases of employee ownership, the Vermont Asbestos Group.[36]

The result of this lack of planning can be employee disenchantment after a few years. In this respect, ESOPs and cooperatives have clear advantages in that they specifically address questions of stock ownership and employee voting rights (although ESOPs, unlike coops, have no requirements for employee participation in management and many ESOP promoters oppose the idea). Nonetheless, this is not an inherent disadvantage for direct ownership. The problems of ownership transfer and employee participation can be resolved, but they must be addressed at an early stage, prior to the disappearance of a majority of the stock or the alienation of employee owners.

While direct ownership is the simplest way of transferring ownership to employees from a financial standpoint, it does not offer the tax benefits available to employee owners under an ESOP (the ability to deduct principal and interest repayments on the loans used to buy the company—employee owners in the direct ownership model can only deduct their interest, or nothing at all if they used their own savings) or coops (the ability to return profits to employees without having the company pay taxes on the profits). The value of these tax savings will vary from case to case, but certainly should be a consideration when employees purchase a company.

IV. Transfer of Ownership to Employees

The previous sections have explored the three basic modes of employee ownership and in so doing have discussed how each can be used to transfer ownership to employees. In this section, the reasons for transferring ownership to employees and the obstacles involved in doing it will be discussed.

Transfer of ownership occurs primarily under four conditions: (1) A company sets up an employee stock ownership plan as an employee benefit, usually either to provide an incentive to employees or to help finance expansion (or both), (2) a conglomerate decides to divest itself of a subsidiary, (3) an independent owner dies, retires, or leaves the business, and (4) an owner decides to give his company to his employees.

ESOPs have been discussed in detail above. This form of transfer is generally intiated by the employer and results in employees owning a minority of company stock, although there are cases, such as Hallmark Cards, in which employees will eventually own a majority of the stock. The use of an ESOP by management does not need further elaboration at this point, however.

---

[36] Zwerdling is again insightful on this point. See Zwerdling, *op. cit.*, pp. 53–76.

A decision by an owner to give his company to his employees is, to the committee's knowledge, very rare, although a few cases have been documented.[37] The practice appears unusual enough, however, not to merit discussion here.

The other two cases are more common and more interesting, and both involve the actual sale of a company to its employees. As such, they provide potential for saving jobs and business activity in communities that would otherwise lose them, or for preventing independent or potentially independent businesses from being swallowed by conglomerates.

Sockell has concluded that almost all of the cases of employees purchasing a firm have occured in this decade, with the exception of the plywood companies.[38] Of these purchases, the large majority appear to be corporate divestitures.[39] Precise data are not available on all instances of known employee purchases, however, so estimates such as these are only approximate.

It may appear at first blush that a company that could not survive as a subsidiary of a conglomerate will also not survive as an employee owned firm. This, however, is often not the case. In many cases, a conglomerate sets certain rates of return (typically around 15 percent) it expects from its subsidiaries. If they do not achieve these rates, they are closed or sold. Employee owners, however, may well be satisfied with a lower, but still profitable, rate of return, since their jobs are at stake. In other cases, a conglomerate may simply find that a subsidiary does not fit into its current plans, or that it needs the cash that would result from a sale. Finally, conglomerates may mismanage firms, saddling them with substantial overhead costs or making inappropriate decisions. Even a subsidiary that is well run, moreover, might be better run by employee owners, since their new owners would presumably work harder than before.

Sociologist William Whyte, who is heading a research project at Cornell University's School of Industrial and Labor Relations on this project, has cited these reasons and others as the explanation for the fact that, to the knowledge of researchers in the field, of the companies which have had employee takeovers in this decade, all are still in operation, and many have been turned from money losers into profit makers.[40] Given what many economists see as the over-acquisition of the sixties and seventies, there could be ample opportunities for employee ownership in the years ahead.[41] For employees and communities where conglomerates have erred, employee ownership may be the only way out of a desperate situation.

For independent owners who are retiring, leaving their company, or who have died, transfer to employees may be a very attractive alternative. An extensive survey of owners of wholesale distributing companies showed that few have given serious thought to this problem, and most had unrealistic expectations about prospects for their company's sale.[42] Although use of the techniques is still uncommon, its advan-

---

[37] See Zwerdling, *op. cit.*, pp. 113–130.
[38] Sockell, *op. cit.*
[39] Sockell, *op. cit.*
[40] William Whyte; "In Support of the Voluntary Job Preservation and Community Stabilization Act", p. E3326 of the *Congressional Record* of June 19, 1978.
[41] "How To Buy Your Own Company", *Dun's Review*, November 1977.
[42] "Profile of the Perpetuation Crisis", National Association of Wholesale Distributors, 1975, p. 5.

tages—creating a market for the owner, preserving jobs for the employees, and providing an opportunity for the owner to see his company perpetuated as an independent business—suggest that it deserves much more serious consideration.

Despite the clear advantages of selling to employees, many conglomerates or individual owners are reluctant to do so. In some cases, an owner or conglomerate can sell a company to another company through an exchange of stock. Such exchanges are not taxed, whereas cash purchases are treated as capital gains. Using an ESOP can reduce some of the tax disadvantage in some situations, but not all. Many sellers simply do not take the idea of employee ownership seriously and refuse to negotiate with employees or fail to provide notice far enough in advance so that employees can organize. In some cases, a company can gain more through a liquidation sale and tax writeoff than it could through a sale, while in others a company is closing a subsidiary in one place to relocate elsewhere, and does not want anyone to own its former plant, since it would be a competitor.

Research on failures of employees to buy their firms is, unfortunately, very limited, but it appears that more important than any of the above reasons for failure is simply the inability of employees to raise the capital needed in a short enough time.[43] The problems in raising the money are obvious: employees must be organized quickly around a novel idea, cash must often be raised from low asset employees, and creditors must be convinced that an unconventional approach can work. Every case with which the committee is familar in which employees succeeded in making the purchase has involved something extraordinary: A benevolent owner, and exceptionally talented organizer, or government assistance—assistance almost always prompted by the intervention of a Senator or Congressman.

The problems of transition, of course, suggest a role for the federal government as a source of credit or credit guarantees. The idea has intuitive appeal: in any case in which a firm would otherwise close or relocate the government has, in effect, two choices. It can pay unemployment insurance and possibly food stamps and welfare to unemployed workers or it can loan the workers money for buying the plant and keeping their jobs. In the first case, the money is a permanent transfer; in the second, it is a loan and, presumably, most of the loans will be repaid. As the next section will indicate, however, government involvement in employee ownership has been spotty and generally reluctant.

V. Government Support for Employee Ownership

In this section, government support for employee ownership will be reviewed. As tax support for ESOPs has already been discussed, this section will focus on loan programs for employees who attempt to buy their businesses. There are four potential sources of funds: EDA's title IX program; SBA's 7a program, Farmers Home Business and Industrial Loans, and Loans to Producer Coops from the Cooperative Bank.

The Economic Development Administration, an agency of the Commerce Department, can grant and loan funds under its Title IX

[43] Robert Stern and Tove Helland Hammer, "Buying Your Job: Reconsiderations on Recent Experience", paper delivered at the 9th World Congress of Sociology, Uppsala, Sweden, Aug. 14–19, 1978.

program for business development in areas of high unemployment. EDA regulations require that assistance be given on a priority basis to areas affected by defense realignment, Environmental Protection Agency caused plant shutdowns, and disasters. All other assistance under this title receives lower priority. Nonetheless, to the committee's knowledge (records are not available with precise information) EDA has assisted nine employeee organizations to purchase their companies, either through low-interest loans or grants to local agencies who in turn use the money to make loans to the employee organizations. In at least some of the cases, the assistance was a result of political pressure on the agency, but at least some of the agency's administrators have shown enthusiasm for the idea. Given the agency's required priorities, however, it is doubtful that EDA assistance can expand beyond its currently very limited scope without specific Congressional action. A proposal along these lines will be discussed later.

The Small Business Administration can make loans and guarantee loans under its 7a program. Direct loans are limited to $350,000 and guarantees to 90 percent of the loan for not more than $500,000. SBA has guaranteed three loans to employee organizations and appears to be about to guarantee a fourth. The SBA will not, however, make or guarantee loans to an ESOP. SBA regulations state that an ESOP is not a small business and that the advantages of an ESOP could be obtained in other ways.[45] While it is true that an ESOP or its trust is not formally a small business, it is simply a creation of a business, and its loans are formally guaranteed by the business. The distinction between the ESOP and the business is purely a paper distinction, and Senators Nelson and Long have expressed their disappointment and disagreement with the SBA position on this matter. Moreover, while it is true that in some cases a bsuiness could get the tax advantages of an ESOP without setting one up, as pointed out earlier, the employees benefit more if an ESOP is established than if an ESOP alternative is created. As was also pointed out, ESOPs are excellent tools for employee purchase of businesses, and there are on alternative methods of accomplishing the same tax purposes in this case. Since the SBA has stressed to the staff their concern with making loans to preserve or (in the case of a spinoff of a subsidiary) create independent small businesses, their refusal to make loans to ESOPs, which accomplish this extremely well, seems very contradictory and shortsighted.[46]

The loans SBA has guaranteed, then, have been in non-ESOP cases, but, even here, SBA officials have told staff that they do not see making loans to employee organizations as consistent with the primary purpose of the agency (as they see it), namely to assist individual entrepeneurs. Given SBA guidelines for making loans, which include sufficient collateral on the part of those receiving the loans, it is easy to understand why the SBA, at this time, is not likely to be a primary source of loans to employees. If SBA were to become an effective force in this area, its rules on ESOPs would have to be changed and its evaluation of loans to employee organizations would have to be based on an assessment of the future prospects of the company.

---

[45] Letter from A. Vernon Weaver, Administrator, SBA, to the Honorable Russell Long, May 15, 1978.

[46] See Jan. 23, 1958, SBA memo reprinted in Opinion Digest, No. 56, Feb. 26, 1965 for SBA policy of encouraging the preservation and creation of small business.

The Farmers Home Administration also can make loan guarantees to employees and has done so in one instance (Bates Fabric in Maine). FmHA loans are not restricted by size of firm and can be as large as necessary, but must be made to businesses in places of 25,000 people or less, FmHA does, however, encourage small businesses even in these areas to approach SBA. Farmers Home officials have expressed enthusiasm about the idea of employee ownership to the staff, but said that they have not had many inquiries. For businesses in qualified areas, then, FmHA might be a logical place to seek credit.

Finally, the Cooperative Bank, created by the 95th Congress, can make loans to producer coops. There is a $10 million limit on these funds, since the bank was primarily intended for consumer coops. The program is just beginning, but could provide a modest source of capital for employee ownership.

Overall, then, government involvement has been limited—probably less than 15 or 20 percent of the cases of employee ownership known to the committee involved government assistance. As the next section will make clear, however, the government could stand to benefit itself and the country significantly by becoming more involved in employee ownership.

VI. Evaluating Employee Ownership

Employee ownership of companies has worked. The overwhelming preponderance of evidence shows that employee owned firms are both more profitable and productive than similar conventional firms and that employee ownership results in better working conditions for everyone. Most importantly, where employees have bought their companies, it results in the preservation of jobs that would otherwise be lost. This is not to say that there are not pitfalls in employee ownership—a program for the support of employee ownership could result in aiding shaky businesses to take advantage of their employees if not carefully administered, and even successful employee owned firms have had difficulty determining the role employees should play in management, but the overall record of employee ownership is very impressive.

In a study of the plywood industry, Paul Bernstein found that employee owned firms had 30 percent higher productivity and 25 percent higher wages than conventional firms.[46] In addition, of course, each employee owner has equity in the company. In the Survey Research Center study of 100 employee owned firms, profits were 1.5 times higher in employee owned firms than non-employee owned firms, and the greater the equity owned by employees, the higher the profits (the study included a variety of ownership arrangements, from a minority employee ownership arrangement to full ownership).[47] Managers surveyed in the study reported much higher levels of employee satisfaction with employee ownership compared to the prior conventional ownership of their companies.[48] They also contended that employee ownership improved productivity and work atmosphere.[49]

---

[46] Paul Bernstein, "Worker-Owned Plywood Firms Steadily Outperform Industry," World of Work Report, June 24, 1977.
[47] *Employee Ownership, op. cit.*, p. 24.
[48] *Employee Ownership, op. cit.*, p. 30.
[49] *Employee Ownership, op. cit.*, p. 36.

The idea of employee ownership is also a popular one; a 1975 national poll by Hart Research showed that a margin of 66 percent to 25 percent would prefer to work in an employee owned firm.[50]

Perhaps the most important data, however, concerns the companies who would have gone out of business had employees not bought the company. Of the companies purchased by employees in the seventies, to the knowledge of the staff and researchers in the area, all are still in business, and many are succeeding where predecessors were failing. All told, perhaps 50,000 to 100,000 jobs have been saved. As a job creation program alone, employee ownership would compare very favorably to government funded public works jobs.

There are problems as well, however, Employee participation in management is often not planned, resulting in disenchantment of workers. According to the Survey Research Center, only about half the ESOP companies allow significant employee input into decisions and only 27 percent allow employees to vote their stock. By contrast, non-ESOP firms almost unanimously allow voting rights, and generally (77 percent of the firms) allow for employee input into major decisions.[51] Sockell's more detailed study of the issue showed that of 32 firms surveyed, only nine allowed direct participation in management by employees, although 23 allowed stock to be voted.[52]

Arguments can be made on either side of the issue of employee participation in management, but research conclusively shows that productivity increases with worker participation.[53]

Research by Zwerdling cited above showed that when such participation is not allowed, workers-owners become alienated. While still pleased to have their jobs, they feel their equity position should give them more of a say in company operations. At the very least then, companies contemplating employee ownership should give serious thought to worker participation and be prepared to allow as much participation as possible.

Finally, it is possible that employees could be sold a company that was dying or had poor prospects. This happened in a few cases in the plywood industry in the fifties, although there are no apparent cases of it in the wave of employee takeovers in the seventies. ESOP plans could be used to reduce employee compensation or to substitute stock in a weak company for a pension fund. At this point, however, these problems seem to have been very minor compared to the success of the idea of employee ownership. Moreover, there is no reason why employees are not capable of making sound financial decisions, nor is there any reason to believe that the government would be unable, when it makes loans to employee organizations, to avoid assisting weak companies take advantage of their employees. These dangers should be avoided, but they should not be allowed to prevent the government from encouraging what has been an extremely successful experiment.

VII. Case Studies

Some of the points made above can best be illustrated by specific examples. The following section will, therefore, briefly detail instances of employee takeovers of firms.

---

[50] Quoted by Whyte in Whyte, *op. cit.*
[51] Employee Ownership, op. cit., p. 21.
[52] Sockell, *op. cit.*
[53] Paul Blumberg, *Industrial Democracy* (London: Constable, 1968), p. 123. Blumberg cites a number of studies to this effect.

SOUTH BEND LATHE

In 1975, Amsted Industries, a Chicago based conglomerate, decided to liquidate its South Bend Lathe subsidiary. The company employed 500 people and, although one of the few lathe manufacturers in the country, was just barely breaking even. SBL executives believed that with proper management, the company could make a profit, however, and decided to try to purchase it themselves. The executives joined with the union and city officials (South Bend was still recovering from the loss of Studebaker years before) and took their case to the EDA. EDA quickly agreed to grant $5 million to the city which in turn loaned the money to SBL's newly created ESOT. With this as a start, the company was able to secure another $4.5 million (roughly) and purchase the plant from Amsted. The employees in this arrangement put up none of their own money, but as the loan is repaid over 25 years will gradually build up equity in the company (the employees will have a percentage of the stock vested prior to the full 25 years, however). The loans are secured by the company's assets, which were worth at least the $10 million paid for the company.[54]

After the first year, the company had 20% higher productivity and 10% more pretax profits than the year before, and has continued profitably since. A typical employee at the plant accumulated about $2,000 in stock in his or her ESOP account.[55] While the reports of SBL's success have been glowing, there are reports that workers feel that the plant continues to operate as before as far as their role is concerned, and that greater employee participation is needed.[56]

VERMONT ASBESTOS GROUP

One of the most publicized employee ownership stories is that of the Vermont Asbestos Group. In late 1974 the GAF company decided that new EPA regulations and declining profits at its Vermont asbestos mine subsidiary made the mine no longer profitable and decided to close it. In Vermont's depressed Northern Kingdom, the closing of the mine meant that the almost 200 workers would have a difficult, if not impossible, time in finding new employment. Spurred by an aggressive former maintenance supervisor, the employees decided to try to buy the company. After a long and difficult process, employees were able to raise $100,000 and finally convince enough banks and the SBA to loan them enough money ($2.15 million) to buy the company from GAF. GAF agreed to sell the company for $400,000—a very good price. In the next year, the VAG, as the company was now called, installed all the needed pollution equipment.

In the next few years, fortuitous events in the world market made VAG a tremendously profitable company. Employee owners' wages went up substantially and the value of the stock, most of which was owned by employees, increased in value from $50 a share to $3,500 a share in 1976. Unfortunately, the company was not able to cope with success. Worker-owners were not pleased with the limited role they were playing in management, and disputes over how much money to

---

[54] *Newsweek*, Sept. 1, 1975, p. 49.
[55] *Time*, Oct. 4, 1976, p. 80.
[56] Zwerdling, *op. cit.*, 63–76.

reinvest and how much to redistribute were frequent. The originator of the employee ownership movement lost his leadership position in the company, and many employees sold their stock. Unofficial reports now say that a majority of the stock is owned by one local individual.[57]

The VAG experience shows the potential that employee ownership has for saving jobs, but it also shows the need for planning ways to keep stock in the hands of workers if the goal of employee ownership is to be maintained, and the need to come to grips with the fact that when employees become owners they may demand a greater role in management.

MOHAWK VALLEY CORP.

In early 1976 the Sperry Rand Company announced plans to close its Library Bureau division in Herkimer, New York. The Bureau had been making a small profit, but less than what Sperry expected from its subsidiaries. Library Bureau managers and employees were convinced that the company, which makes library furniture and has several hundred employees, could be profitable enough and has local ownership and organized an effort to purchase the company from Sperry. At first, Sperry was extremely reluctant to sell at all, since it could liquidate for more than the employees were willing to pay. Under intense pressure from Congressional representatives, however, Sperry agreed to sell for $6 million. The employees and members of the community raised $2 million through the sale of stock, with an initial pledge of $1,000 per employee in nonrefundable funds as a pledge to Sperry and to pay for legal and other costs. EDA arranged a $2 million loan and another $2 million was secured from local banks. The company has established an ESOP and the workers will eventually own all the stock in the company.

During its first year of operation the company made a profit, but during its second broke just about even. Company officials attribute that to the cost of the loans and expansion, plus a loss of business as a result of uncertainty on the part of customers during the transition period. Company officials are very optimistic about the future, however.

As in other companies, employees have a limited role in management, but, in this case, this is partly the result of the wishes of the employees, who have not actively sought a role in management decision.[58]

JONES AND PRESNELL

When the W. T. Grant Co. went bankrupt in 1976, one of its subsidiaries, Jones and Presnell, a firm specializing in color photographs of children, decided to try to survive on its own. The company set up an ESOT, which was able to secure a bank loan to buy the company from W. T. Grant. The loan was for $3.5 million, and another $1 million was raised from company capital and an existing profit sharing plan. During the first year of operation, company employees took voluntary salary cuts, but by the end of the year, the company has succeeded in stabilizing its business and, as of the time of the report on

---

[57] Data for the above information comes from a report by Edgar May, "Mining for Jobs and Profit," Springfield, Vt., 1977. Reports of the end of worker ownership in VAG are from several people following the situation.

[58] Information on the Mohawk Valley Corp. is from conversations with company officials and staff and from testimony at a hearing in Jamestown, N.Y. on employee ownership held by Congressman Stanley Lundine, Nov. 20, 1978.

which this is based was published, seemed well on its way to financial stability.[59]

KASANOF'S BAKERY

In 1976 Fink Baking Co. of Brooklyn decided to close its subsidiary, Kasanof's Bakery, a profitable Boston bakery employing almost 300 people in the Roxbury section of the city. Although the company had been making a profit, labor problems and a long legal dispute over the noise levels of the bakery made future prospects very uncertain. The company had a good reputation and dedicated customers, however, and the employees, spurred by a local self-management group, made an effort to buy the firm. While this organization was getting started, the plant was closed and the workers went on unemployment. Despite that, and despite the fact that most were low income workers from the poor Roxbury area, they were able to raise $200,000 from funds owed them by the company for vacation pay and a smaller additional amount from their own savings, which were already depleted by their unemployment. The workers would use the $200,000 plus as a down payment and finance the acquisition of the company with a $1.8 million bank loan, hopefully guaranteed by EDA and/or SBA. The company's owners, however, insisted on an additional $20,000 per month to cover security and other costs of keeping the plant open. The workers would not be reimbursed any of this money, even if the deal failed. Unable to raise the $20,000 and unable to get a decision from the government agencies, the employees gave up and the plant closed.[60]

Of course, there are numerous other examples, but few have been documented very well—stories concerning the initial transition appear in newspapers, but followup stories are hard to find. Research at Cornell has confirmed the continued existence of most the companies, but little is known at this point about individual company performance. Related research at the Survey Research Center has provided information on the overall success and characteristics of the companies, but the individual cases on which that data are based are not available to the public. The cases here represent a sampling of some typical examples where information is available in some detail, but should not be taken as a basis for generalizations. For instance, in these examples, government involvement was much more significant than it usually is. All of the cases were medium sized firms, whereas, as previously pointed out, firm size varies from several to several thousand. What can be generalized is that in each case that succeeded jobs were saved and companies went on to make profits. The comparison with the Kasanof case, where the government paid hundreds of workers months of unemployment, is instructive.

VIII. Legislation

In addition to tax legislation for ESOPs discussed above, during the 95th Congress, Congressmen Kostmayer, Lundine, and McHugh introduced H.R. 11222, "The Voluntary Job Preservation and Community Stabilization Act". The bill would create a $100 million loan

---

[59] *Wall Street Journal*, "Jones and Presnell, a Grant Unit, Survives Via Leveraged Employee Ownership Plan." July 22, 1976, p. 6.

[60] Information in this section from *the Boston Phoenix*, Apr. 26, 1977.

fund in EDA to make loans to employees and employee organizations who are purchasing plants that would otherwise close or relocate. In approving the loan funds, the administrator of EDA would first require a feasibility study, for which EDA could also loan funds, which would have to include a plan for repayment of the loan, with provisions for employee payroll deductions if necessary. The bill allows for members of the community to participate in ownership as well. The bill attracted approximately 75 cosponsors, and will be reintroduced in the 96th Congress. Senator Nelson will introduce a similar, but not identical, bill in the Senate in that Congress.

Senators Nelson and Long will also introduce a bill in the Senate to require that the SBA include ESOTs as eligible for SBA loans and loan guarantees under all SBA programs. The bill will also encourage the SBA to make loans to employee organizations seeking to purchase their companies when they would otherwise close, relocate, or be purcased by a large business. Again, feasibility studies would be required, and loans could be made for this purpose. The bill would require, however, that the assessment of the soundness of the loan be based on the feasibility report for the company's prospects, and not on the individual assets of employees.

The advisability of such legislation most likely will be challenged on the basis of the risk the government is taking in making loans to employees or employee organizations. Even if individual employees were held liable for their portion of the loan, collecting the loan from individuals who have left the company, or from all the employees should be company fail, would be impractical and probably impossible. Moreover, this lack of direct liability could encourage some business owners to sell to their employees when their company is failing and other buyers cannot be interested.

These arguments have some merit but are not, on the whole, persuasive. Any loan to the employee organization, whether to an ESOT or to the company itself, would be secured by the assets of the company, so the government's liability would be limited to the difference between the worth of the assets and the amount of the loan or loan guarantee. In any loan guarantee, the pledge of the borrower's personal assets is more a test of good faith than a source of likely funds for repayment in the case of default.

Of course, with employees, this test of good faith may be lacking if there is no practical way to make individuals responsible. This presents two problems: (1) Cases where employee owners simply walk out on a firm; and (2) cases where employee owners are sold a bad company. In the first case, the problem is substantially alleviated by the fact that the employees stand to lose their jobs if the loan is not repaid, and there is likely to be considerable effort on their part, therefore, to make the company succeed at all costs. Data on employee owned firms confirm this argument. The threat of employees gullibly buying a company with poor prospects, figuring that they will not be liable if it fails, is more serious, but the agencies and the banks making the loan will have a feasibility report which should help them weed out such cases. Moreover, in most cases of employee ownership for which information is available, employees have put up some of their own money to buy the company, and even in ESOP arrangements where they do not, in the first few years, most employees accumulate

thousands of dollars worth of stock in the ESOT, which they will not get if the company fails.

What this suggests is that in making loans to employee organizations, the fact that individual employees may not be liable does introduce an element of risk not present when a conventional loan is made. This risk, for the reasons cited above, is small, however, and should be offset by the fact that employee owned firms are more successful than non-employee owned firms. In general, loans to employee owned firms should be more likely to be repaid, then, if these data are considered. All current loans to employee owned firms from the government (13) are being repaid.

Any decision to proceed with a government program should proceed on the basis of comparing alternatives, however. When a plant is closing or relocating, the government has a choice: it can make a loan, which will have a good chance of repayment, although one might argue whether the chance is as good as a conventional loan at this early date, or it cannot make a loan. If it does not make a loan, it will pay unemployment insurance and possibly food stamps, welfare, public works employment, or CETA money as well. Clearly, if there is a reasonable chance that the company could succeed as an employee owned firm, a loan to preserve the jobs would be vastly cheaper than the alternatives, as well as substantially more productive for the employees and the community.

In addition to these loan programs, it should be noted that Senator Long may introduce further legislation to encourage ESOPs through the tax system.

CONCLUSION

Employee ownership of business is still in its very early stages in this country, and government involvement in the process has been limited. Nonetheless, the experience with employee ownership so far has been very positive and encouraging. Employee ownership of business could provide a way to save jobs, save businesses, increase productivity, and spread the benefits of capitalism—goals the government has spent billions to achieve in the past. For much smaller sums, in the forms of loans and limited tax incentives, the government may be able to accomplish the same goals by supporting this promising form of free enterprise.

LIST OF EMPLOYEE OWNED FIRMS

1. A. C. Lawrence Leather Co., Paris, Maine.
2. Advance Micro Devices, Sunnyvale, Calif.
3. Algoma Plywood, Algoma, Wis.
4. Allied Plywood, Alexandria, Va.
5. American Cast Iron Pipe Co., Birmingham, Ala.
6. American Tube and Controls, West Warwick, R.I.
7. Arrow Lakes Dairy, Cranston, R.I.
8. Associated Freight Lines, Oakland, Calif.
9. Astoria Plywood, Astoria, Oreg.
10. Bates Fabrics Inc., Lewiston, Maine.
11. Beyda Stores.
12. Boston Consulting Group, Boston, Mass.
13. Brookings Plywood, Brookings, Oreg.

14. Brooks Camera, San Francisco, Calif.
15. Buffelin Woodworking, Tacoma, Wash.
16. Chicago and Northwestern Trans, Chicago, Ill.
17. Crosby Valve, Wrenthan, Mass.
18. Elma Plywood, Elma, Wash.
19. Everett Plywood and Door, Everett, Wash.
20. Fairbanks Daily News Miner, Fairbanks, Alaska.
21. Fort Vancouver Plywood Co., Vancouver, Wash.
22. Gladding Corp., Gladding, Maine.
23. Graybar Electric, New York, N.Y.
24. Great Western Inorganics, Golden, Colo.
25. Hardel Mutual Plywood, Olympia, Wash.
26. Hoguiam Plywood, Tacoma, Wash.
27. Huebner Publications, Solon, Ohio.
28. Infant's Specialty, San Francisco, Calif.
29. Independent Mining & Mfg., Connellsville, Pa.
30. International Group Plans, Washington, D.C.
31. International Poultry, Willamantic, Conn.
32. Jamestown Metal Products, Jamestown. N.Y.
33. Jones and Presnell Studios, Charlotte, N.C.
34. Kansas City Star, Kansas City, Mo.
35. Katz Agency, New York, N.Y.
36. Kreamo Bakers, Inc., South Bend, Ind.
37. Lacey Plywood, Lacey, Oreg.
38. Lionel D. Edie & Co., New York, N.Y.
39. Linton Plywood, Portland, Oreg.
40. Manalytics, San Francisco, Calif.
41. Marott Shoes Stores, Inc., Indianapolis, Ind.
42. Medford Veneer, White City, Oreg.
43. Merchant & Evans Co., Mt. Laurel, N.J.
44. Milwaukee Journal Co., Milwaukee. Wis.
45. Mohawk Valley Community Corp., Herkimer, N.Y.
46. Mt. Baker Plywood, Bellingham, Wash.
47. Mullach Steel, Bridgeville, Pa.
48. Multnomah Plywood, Portland, Oreg.
49. Muses (Menswear), Atlanta, Ga.
50. National School Studios, Bloomington, Minn.
51. North Pacific Plywood, Tacoma, Wash.
52. NWL Transformers, Bordentown, N.J.
53. Okonite Corp., Ramsey, N.J.
54. Operations Research, Inc., Silver Spring, Md.
55. Pacific Paperboard Products, Stockton, Calif.
56. Paine Lumber Co., Oshkosh, Wis.
57. Peninsula Newspaper, Palto Alto, Calif.
58. Puget Sound Plywood, Tacoma, Wash.
59. Radio Distributing Co., Inc., South Bend, Ind.
60. Rich-Sea Pak Corp., Brunswick, Ga.
61. Saski, Walker, Roberts & Ass., Sausalito, Calif.
62. Saratoga Knitting Mills, Saratoga, N.Y.
63. S–B Printers, Honolulu, Hawaii.
64. South Bend Lathe, South Bend, Ind.
65. Squire Heating Supply Co., Columbus, Ohio.
66. Stevenson CoPly, Washougal, Wash.

67. Sullair, Michigan City, Ind.
68. Spartan Motors Inc., Lansing, N.C.
69. Vermont Asbestos Group, Eden, Vt.
70. Washington Plywood, Tacoma, Wash.
71. Webb's City, St. Petersburg, Fla.
72. Western States Plywood, Port Orford, Oreg.
73. Woodland Mobile Homes, Mountain View, Calif.
74. Luna Beverage Distributors, North Babylon, N.Y.

POTENTIAL WORKER-OWNED FIRMS [1]

1. Abrogast Bastion, Allentown, Pa.
2. Bearing Specialty, San Francisco, Calif.
3. Natural Beers Inc., Yonkers, N.Y.
4. Crows Publications, Portland, Oreg.
5. Steiger Tractor, Fargo, N. Dak.
6. SWA Group, Sausalito, Calif.
7. Summers Electric, Dallas, Tex.
8. Resistance Corp., Bremen, Ind.
9. Gray Tool, Kansas City, Mo.
10. Hallmark Cards, Kansas City, Mo.
11. Hatfield Packing, Hatfield, Pa.
12. Construction City.
13. Devor Nursery, Pleasanton, Calif.
14. First Bank Shares, Boca Raton, Fla.
15. W. H. Newholds Son Corp., Philadelphia, Pa.
16. O'Conner Lumber Co., Mass.
17. San Mateo Times, San Mateo, Calif.

In addition, Western Bank and Trust of California has apparently sold 41 of its units to employees.

ADDENDUM

Since the first printing of this study there have been a number of developments. On February 8, 1979, Senators Nelson, Stewart, Hatch, Weicker and Pressler introduced S. 388, the Small Business Employee Ownership Act. This bill would authorize the Small Business Administration to guarantee loans to ESOTs and to employee organizations seeking to purchase their businesses when they would otherwise close or relocate. A companion bill, H.R. 2480, was introduced on February 28 in the House by Congressmen Baldus, Kostmayer, Bedell and Daschle. On February 27, 1979 the Senate Small Business Committee held hearings on S. 388, and a majority of the committee is now committed to the bill. The Small Business Administration, in the meantime, has revised its stance on employee ownership, and has said that it would reconsider the issue. In addition, the SBA, with some reservations, gave its support to S. 388.

---

[1] Firms with plans to become employee-owned in the next several years.

Congressmen Kostmayer, Lundine and McHugh reintroduced the Voluntary Job Preservation and Community Stabilization Act in the House, and a similar bill will be introduced in the Senate in mid-March by Senators Gravel, Nelson, Heinz, and Hatfield. Senator Williams will be introducing legislation also containing employee ownership provisions, along with provisions requiring pre-notification of plant closings providing for certain employee protections when a plant closes.

The Farmers Home Administration continues its policy of placing a high priority on employee ownership, and the Department of Housing and Urban Development is considering ways to use its urban development action grant program to encourage employee ownership. The Carter administration is drafting legislation to create a national development bank within the Economic Development Administration, and has asked staff members of the offices involved in the employee ownership concept to assist in drafting provisions in that legislation.

○


A11600 777440